

1/1. Examinable syllabus guide for

December 2025 to June 2026 according to ACCA

Financial instruments- Presentation

- Determine the appropriate classification of a financial instrument, including compound financial instruments – e.g. convertible bonds.

After studying our material and solving related questions, please refer back to the points above to make sure you fully cover it well.

1/2. Classification and Presentation of

Financial liability V.S equity instrument

1. *When* an issued financial instrument is classified as **liability**; gearing increases as **debt/equity ratio** and **debt ratio** increase *thus*; the issuer's **default risk** increases *consequently* the issuer's creditworthiness is negatively affected.

In the absence of appropriate guidelines, most issuers tend to classify their **issued financial instrument** as **equity**.

2. IAS # 32 addresses **classification** and **presentation** of **issued** financial instruments as follows:

A. The **issuer** of the financial instrument must **classify** it *or* its component parts as **liability** *or* **equity instrument** on **initial recognition** based on **substance** of the contractual arrangement of the instrument and **definition** not merely its legal form.

♦ 'Substance' here relates to consideration of the contractual terms of the **instrument**.

♦ *When* substance *and* legal form of an **instrument** are different; substance governs the classification *and* presentation.

Illustrative example: Which of the following statements best describe the principle for classifying an issued financial instrument as a **financial liability** *or* **equity**?

A. Issued instruments are classified as **liability** *or* **equity** in accordance with the **substance** of the contractual arrangement *and* the definitions of **financial liability** *and* **equity instrument**.

B. Issued instruments are classified as **liabilities** *or* **equity** in accordance with the legal form of the contractual arrangement *and* the definitions of **financial liability** *and* **equity instrument**.

C. Issued instruments are classified as **liability** *or* **equity** in accordance with management's designation of the contractual arrangement.

D. Issued instruments are classified as **liability** *or* **equity** in accordance with the **risk** *and* **rewards** of the contractual arrangement.

Answer (A) is correct:

B. The existence of **contractual obligation** to deliver **cash** *or* another **financial asset** is what critically differentiates **financial liability** from **equity instrument** *even though* its **form** is an **equity instrument** *but* in **substance** it is a **liability**.

Illustrative example: Cavor issued non-redeemable Class (B) shares that contain a **call option (Callability provision)** allowing Cavor to repurchase them at a **fixed** amount. Dividends are payable on Class (B) shares **if** dividends have been paid on the Class (A) **ordinary shares**. The terms of the Class (B) shares are *such that*; dividends are payable at a rate equal to that of the Class (A) **ordinary shares**.

Required: Discuss *whether* the above arrangement *regarding* the Class (B) shares of Cavor should be classified as **liabilities** or **equity** in its SFP.

Answer: The classification of Cavor's Class (B) shares will be made by applying the **principles-based definitions of equity and liability** under IAS # 32 **and** by considering the **substance rather than** the legal form of the **instrument**. 'Substance' here relates only to *consideration of* the contractual terms of the **instrument**. Factors outside the contractual terms are **not** relevant to the classification.

The following factors demonstrate that Cavor's Class (B) shares are **equity instruments**;

- A. Dividends** are **discretionary** in that they need only be paid **if** paid on the Class (A) shares, on which there is no **obligation to pay** dividends.
- B.** Dividends on the Class (B) shares will be paid at the same rate as on the Class (A) shares which will be **variable**.
- C.** Cavor has **no obligation to redeem** the Class (B) shares.
- C.** Some instruments may combine features of both **equity instruments and financial liabilities** *such as* **convertible bond**.
- D.** The **initial classification** of the **financial instrument** as a **liability or equity** will continue *until* the **financial instrument** is **derecognised** from the SFP.

1/3. Examples of liability instruments

A. Mandatorily redeemable preference share (P/S)

Under mandatorily **redeemable** P/S; the issuer has a future **obligation** to **pay** cash because the instrument has a **limited** life. *Thus; despite its form (share) but in substance redeemable P/S is classified as a financial liability.*

Illustrative example: PQR issued 100,000 **redeemable** P.S^s on 1, Jan, 2019 at \$1 per share with an annual dividend payment of 6 cents per share **redeemable** in 2023 at 20% **premium** on its nominal (face) value.

Required: How the issued **redeemable** P.S^s is **presented** in F/S^s for the year-ended 31, Dec, 2019?

State the effect on gearing.

Answer: **Redeemable** P.S^s *although* called shares' are **not** in substance **equity**, they are **debt** instrument (i.e. a **loan**) with in substance interest payments *and* are paid back at a later date. *Consequently* under IAS # 32 it is **presented** as a **non-current liability** in the SFP. The 'in form dividends' paid will be **recognised** in **P/L** as finance costs *and* accrued at year-end *whether* declared *or not* as per its contractual provisions. The issued P/S is a **financial liability** that held at **amortised cost**. The effective interest rate would be **higher** than the coupon rate of 6% because **redemption** value **exceeds** issuance price. (See IFRS **Accounting Standard** # 9 later in detail). In the F/S^s for the year-ended 31, Dec, 2022 these shares will be reclassified as a **current liability** because they will be repaid *within* one year.

Finally; because the issued P.S^s are classed as a **financial liability**, gearing will be **higher** than *if* they were classified as **equity**.

B. Puttable financial instruments

Putability provision means; the **redemption** is at the **option** of the instrument holder;

Examples: P.S^s issued *when* the holder can require the issuer to **redeem** it for cash at agreed-upon price.

C. Cumulative P/S

An issued **cumulative** P/S is a **financial liability** *even if* it is **irredeemable** because the issuer has a future **obligation** to **pay** arrears. *Thus;* its dividends are **non-discretionary**.

Note: *When* P/S is cumulative, dividends that are not declared in one year must be paid in later years before ordinary shareholders can receive any dividends).

D. Financial instrument issued with contingent settlement provisions

1. *When* the entity **issues** a financial instrument *such as* **convertible bond** that can be settled *by the holder's option* through either receiving cash *or* receiving the issuer's ordinary shares depending on the occurrence *or* non-occurrence of uncertain future events beyond the control of the holder *and* issuer *such as* the issuer's share reaching a set price, the financial instrument issued is **classified** as a **financial liability**.

2. *When* the entity **issues** a financial instrument *such as* **convertible bond** that can be settled *at the issuer's option* through either paying cash *or* issuing its ordinary shares, *if* the issuer **can't unilaterally avoid** settlement by delivering cash *or* other **financial asset** *and* **can't** guarantee delivering **fixed** number of its own **equity** for the amount

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Answer: **Redeemable** P.S^s *although* called shares^s are **not** in substance equity, they are **debt instrument** (i.e. a **loan**) with in substance interest payments *and* are **paid back** at a later date. *Consequently* under IAS # 32 it is **presented** as a **non-current liability** in the SFP. The 'in form dividends' paid will be **recognised** in **P/L** as finance costs *and* accrued at year-end *whether declared or not* as per its contractual provisions. The issued P/S is a **financial liability** that held at **amortised cost**. The effective interest rate would be **higher** than the coupon rate of 6% because **redemption** value exceeds issuance price. (See IFRS **Accounting Standard** # 9 later in detail). In the F/S^s for the year-ended 31, Dec, 2022 these shares will be reclassified as a **current liability** because they will be repaid *within* one year.

Finally; because the issued P.S^s are classed as a **financial liability**, gearing will be **higher** than *if* they were classified as equity.

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D. Financial instrument issued with contingent settlement provisions

1. *When* the entity **issues** a financial instrument *such as* **convertible bond** that can be settled *by the holder's option* through *either* receiving cash *or* receiving the issuer's ordinary **shares** depending on the occurrence *or* non-occurrence of uncertain future events **beyond the control** of the holder *and* issuer *such as* the issuer's share reaching a set price, the financial instrument issued is **classified** as a **financial liability**.

2. *When* the entity **issues** a financial instrument *such as* **convertible bond** that can be settled *at the issuer's option* through *either* paying cash *or* issuing its ordinary **shares**, *if* the issuer **can't unilaterally avoid** settlement by delivering cash *or* other **financial asset** *and* **can't** guarantee delivering **fixed** number of its own **equity** for the amount received from such financial instrument, the issued financial instrument is **classified** as a **financial liability** *unless* the possibility of settlement in cash *or* other **financial assets** is remote.

Illustrative example: Lidan issued 2m Class (B) shares of nominal value \$1 each **redeemable** in two years' time. Lidan has a choice to redeem it for cash at their nominal value of \$2m *or* issue 1m Class (A) shares.

Class (A) shares are currently valued at \$10 per share. The lowest price for Class (A) shares since formation has been \$5 per share.

Required: Discuss *whether* Class (B) shares should be treated as **liability** *or* **equity** in Lidan's F/S⁵.

Answer: A **financial liability** under IAS # 32 is an **explicit** *or* **implicit** contractual **obligation** to deliver **cash** *or* another **financial asset** to another entity in the **form** of **obligation** to **pay** interest, dividends *or/ and* principal.

In Lidan's case the contractual **obligation** to **pay** cash is implicit.

At first glance it looks as *if* Lidan has choice of the **redemption** method. *However* the **value** of the settlement in Lidan's shares is **considerably greater** than the cash settlement method. *Thus*; Class (B) shares **redemption** for a **cash** of \$1 per share is **highly probable** because the Class (A) share settlement alternative is **highly expensive** *and* **can't** serve as a means of avoiding classification as a **liability**.

IAS # 32 states that *where* the **issued instrument** has contingent settlement **options**; **all** of the settlement alternatives must result in it being classified as an **equity instrument** *otherwise* it is **initially** classified as **financial liability**.

Thus; Lidan's Class (B) shares must **initially** be classified as a **liability**.

Contingent settlement provisions **differ** from issuing a **compounded** financial instrument *such as* an **issued convertible bond** to fixed number of the issuer's **ordinary shares**; *where* part of proceeds **initially** allocated to **debt** *and* the remainder allocated to **equity**.

1/4 . Examples of equity instruments

1. Issuance of **Non-putable** ordinary shares with no liquidation date.

2. Issuance of **non-redeemable, non-cumulative** P/S that provide for discretionary dividends.

Note: IAS # 32 states that 'issued financial instruments imposing an **obligation** on the issuer to deliver to the holder a pro-rata share of the net assets **only on liquidation** are classified as **equity**'. Thus, issued shares that obligate the issuer to pay cash to the shareholder **only on liquidation** after all **liabilities** is satisfied, are **equity instruments**.

Illustrative example: Peter issued 4m non-redeemable P.S^s for \$2.50 each. A dividend is payable *if* dividends are paid on ordinary shares.

Required: Discuss *whether* the issued P.S^s should be initially classified as **financial liability** or **equity** in Peter's F/S^s.

Answer: A **financial liability** exists *if* there is an **obligation to deliver cash** or another financial asset.

There is **no obligation** for the issuer to **repay** the issued instrument (P.S^s).

Dividends are only payable *if* it paid on **ordinary shares**. Because there is **no obligation to pay** dividends on **ordinary shares**, there is also **no obligation to pay** dividends on this P.S^s.

Thus, the issued P.S^s are not **financial liabilities**. Total proceeds from the P.S^s issue are initially classified as **equity** in the SFP.

3. An issued **derivative** contract *such as* a **share warrant** or a written **call/ put option** that allow the holder to subscribe for or purchase a **fixed number** of the **issuer's** ordinary shares in exchange for a **fixed amount of cash** or another **financial asset** is an **equity instrument**.

Thus *if* the '**fixed test**' under IAS # 32 is satisfied, the issued **derivative** contract is initially classified as **equity**.

The reasoning behind this is that, by fixing upfront the number of shares to be received *or* delivered on settlement of the issued **derivative** instrument, the **derivative** instrument holder (not issuer) is exposed to the upside *and* downside **risk** of movements in the entity's share price.

Illustrative example (1): For \$9,000, Lolo issued **share warrant** that gives the holder the right to purchase 1,000 shares of its own equity (**fixed number**) for a **fixed price** of \$100 each. The amount received of the **share warrant**

(The **derivative**) is classified as **equity** in Lolo's F/S^s.

Initial journal entry:

Dr: Cash \$9,000

Cr: **Share warrant-equity** \$9,000

Illustrative example (2): For \$9,000; Lolo issued (write/ sold) **call option** (**obligation** on Lolo *but* **right** to the **option holder** to buy) that gives the holder the right to purchase 1,000 shares of its **own equity** (**fixed number**) for a **fixed price** of \$100 each. The amount received of the **issued call option** (the **derivative**) is classified as **equity** in Lolo's F/S⁵.

Initial journal entry:

Dr: Cash \$9,000

Cr: Call option on ordinary shares-**equity** \$9,000

Illustrative example (3): For \$9,000; Koko issued **share warrant** that gives the holder the right to purchase Koko's shares worth \$100,000 at a share price determined at the date of the **option** exercise.

Required: Classify the **issued share warrant** in Koko's F/S⁵

Answer: *If* the contract requires the entity to deliver as many of its **own ordinary shares** equal in value to \$100,000 on a future date *then*: the number of shares that will be delivered = \$100,000/ F.V of Koko share at the **option** exercise date. *Thus*; the number of shares would **vary** based on F.V of the share (*if* the share price increases, fewer shares will be delivered *and vice versa*). This **derivative** contract is **initially** classified as a **financial liability**.

Thus: A contract to deliver a **variable** number of **own equity instruments** equal in value to a fixed monetary amount on the settlement date is classified as a **financial liability**.

Dr: Cash \$9,000

Cr: Call option on ordinary shares-**liability** \$9,000

Illustrative example (4): For \$10,000; Nora sold a **call option** that **requires** it to deliver a number of its **own equity** shares equal in value to 100 ounces of gold after one year.

Required: Classify the derivative contract (**call option**) in Nora's F/S⁵.

Answer: The number of Nora's shares that will be delivered will **vary** based on changes in both the share price *and* the gold price.

$$\text{Number of shares to be delivered} = \frac{\text{F.V of 100 ounces of Gold after one year}}{\text{F.V of ordinary share after one year}}$$

If the share price increases, fewer shares will be delivered *and vice versa*. *If* the gold price increases, more shares will be delivered *and vice versa*. This **derivative** contract (written **call option**) is a **financial liability**.

Thus: a contract to deliver as **many** of the entity's **own equity instruments** as is equal in value to the value of 100 ounces of a commodity (gold) *results in* **liability** classification of the instrument.

Dr: Cash \$10,000

Cr: Call option on ordinary shares-**liability** \$10,000

Illustrative example (5): For \$10,000; Zeta sold **share warrant** that **requires** it to deliver a **fixed number** of its **own equity** shares in return for an amount of cash calculated to equal the value of 100 ounces of gold after one year.

Required: Classify the derivative contract in Zeta's F/S⁵.

Answer: This contract is a **financial liability** because the amount of cash to be received is **not** fixed.

Dr: Cash \$10,000

Cr: Share warrant on ordinary shares-**liability** \$10,000

Illustrative example (6): On 28, Feb, 2018 Douglass **sold** for \$8,000; **share options** for 2,000 of its **ordinary shares** in exchange for \$50 per share to be exercised at any time from 28, Feb, 2021.

Required: Identify *whether* the issued (sold/ written) **call option** be classified as **debt or equity** in Douglass F/S⁵.

Answer: Douglass is not obligated to deliver cash *or* another **financial asset** *rather* it is obligated to deliver **fixed number** of its **ordinary shares** for **fixed amount** of cash. *Accordingly* the issued **share option** is classified as **equity**.

Dr: Cash \$8,000

Cr: **Share option** on ordinary shares-**equity** \$8,000

Illustrative example (7): For \$9,000 Soso **purchased** a **call option** that gives it the right to repurchase 1,000 of its own issued **equity instruments** (**fixed number**) for of \$100 each (**fixed price**)

Required: Classify this transaction in Soso's F/S⁵.

Answer:

Dr: **Call option** on ordinary shares → **equity reduction** \$9,000 → **not a financial asset**

Cr: Cash \$9,000

4. A non-derivative contract that will be settled by the entity by receiving (*or* delivering) a **fixed number** of its **own equity instruments** in exchange for **fixed amount** of cash *or* another **financial asset** to be paid (*or* received) is classified as an **equity instrument**.

Thus, if the 'fixed test' under IAS # 32 is satisfied; the issued non-derivative contract is initially classified as equity.

Note: *If* the contract will be settled by the entity *through* receiving (*or* delivering) a **variable number** of its **own ordinary shares**; the **financial instrument** contract would be **initially classified** as **financial liability** because the holder of the **financial instrument** does **not** truly hold a residual interest in the issuer's **equity**.

Illustrative example (1): Olsen issued 2m P.S⁵ for \$2.80 each, no dividends are payable.

The P.S⁵ will be **redeemed** in two years' time by issuing 3.20m **ordinary shares** of \$1.25 par value.

Required: Discuss *whether* the issued P.S⁵ should be initially classified as **financial liability** *or* **equity** in Olsen's F/S⁵.

Answer: The issued P.S⁵ will be settled *through* issuing **fixed number** of the Olsen's **own ordinary shares** (3.20m) in exchange for **fixed amount** of **financial instrument** of \$1.75 per **ordinary share** [(2m P.S⁵ × \$2.80) / 3.20m **ordinary shares**] is an **equity instrument**.

The following entries show the **accounting treatment** in both the issuer's *and* investor's F/S⁵

Description	Issuer view	Investor view
At issuance date	Dr: Cash \$5.60m Cr: P.S ⁵ -equity \$5.60m	Dr: Investment in P.S ⁵ \$5.60m Cr: Cash \$5.60m
Assume F.V of ordinary share is \$1.75 at redemption date	Dr: P.S ⁵ -equity \$5.60m Cr: Share capital (3.20m shares × \$1.25) = \$4m Cr: Share premium (\$5.60m - \$4m) = \$1.60m	Dr: Investment in ordinary shares (3.20 m × \$1.75m) = \$5.60m Cr: Investment in P.S ⁵ \$5.60m Financial assets are initially recorded at F.V
Assume F.V of ordinary share is \$1.50 at redemption date	Dr: P.S ⁵ -equity \$5.60m Cr: Share capital (3.20m shares × \$1.25) = \$4m Cr: Share premium (\$5.60m - \$4m) = \$1.60m	Dr: Investment in ordinary shares (3.20 m × \$1.50m) = \$4.80m Dr: Loss (\$5.60m - \$4.80m) = \$0.80m → P/L Cr: Investment in P.S ⁵ \$5.60m Financial assets are initially recorded at F.V
Assume F.V of ordinary share is \$2 at redemption date	Dr: P.S ⁵ -equity \$5.60m Cr: Share capital (3.20m shares × \$1.25) = \$4m Cr: Share premium \$5.60m - \$4m = \$1.60m	Dr: Investment in ordinary shares (3.20 m × \$2m) = \$6.40m Cr: Investment in P.S ⁵ \$5.60m Cr: Gain (\$6.40m - \$5.60m) = \$0.80m → P/L Financial assets are initially recorded at F.V

Comment: Issued P.S⁵ initially recorded as P.S⁵ when converted; book value method is used to measure the value of the 3.20m ordinary shares no G/L is recognised in P/L because the transaction is with owners at their capacity as owners.

Illustrative example (2): On 30, Sep, 2018 Elisabeth issued 2m P.S⁵ for \$3 each, no dividends are payable. P.S⁵ would be redeemed in three years' time by issuing \$1.25 par value ordinary shares worth \$6m. The exact number of ordinary shares issuable will be based on their F.V on 30, Sep, 2021.

Required: Discuss whether the issued P.S⁵ should be initially classified as financial liability or equity in Elisabeth F/S⁵.

Answer: Elisabeth is obliged to deliver variable number of its own equity worth \$6m therefore the non-derivative contract (issuance of 2m P.S⁵) should be initially treated as debt instruments as per IAS # 32 because the holder of the financial instrument (P.S⁵) does not truly hold residual interest in the issuer's ordinary shares.

The following entries show the accounting treatment in both the issuer's and investor's F/S⁵

Description	Issuer view	Investor view
At issuance date	Dr: Cash \$6m Cr: P.S ⁵ -Liability \$6m	Dr: Investment in P.S ⁵ \$6m Cr: Cash \$6m
Assume F.V of ordinary share is \$3 at redemption	Dr: P.S ⁵ -Liability \$6m Cr: Share capital (2m shares × \$1.25) = \$2.50m Cr: Share premium (\$6m - \$2.50m) = \$3.50m	Dr: Investment in ordinary shares \$6m Cr: Investment in P.S ⁵ \$6m Financial assets are initially recorded at F.V
Assume F.V of ordinary share is \$4 at redemption	Dr: P.S ⁵ -Liability \$6m Cr: Share capital (1.50m shares × \$1.25) = \$1.875m Cr: Share premium (\$6m - \$1.875m) = \$4.125m	Dr: Investment in ordinary shares \$6m Cr: Investment in P.S ⁵ \$6m Financial assets are initially recorded at F.V
Assume F.V of ordinary share is \$2 at redemption	Dr: P.S ⁵ -Liability \$6m Cr: Share capital (3m shares × \$1.25) = \$3.75m Cr: Share premium (\$6m - \$3.75m) = \$2.25m	Dr: Investment in ordinary shares \$6m Cr: Investment in P.S ⁵ \$6m Financial assets are initially recorded at F.V

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2/1. Overview

A **compound (hybrid)** financial instrument is a single instrument that has characteristics of both **equity** and **liability**.

Examples:

A. Issuance of **bonds** with **detachable** share warrants;

B. Issuance of **convertible** bond that can be **redeemed** either in cash or in a **fixed number** of the issuer's **ordinary** shares.

This create a **primary financial liability** of the issuer *through obligation to pay* interest *and* principal on the **bond** *as long* as it is not **converted** *and* grants a **written call option** to the instrument holder (**bond /warrant**) to **convert** it into **fixed number** of ordinary shares of the issuer.

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2/2. Presentation of compound instruments

Under split accounting per IAS # 32

1. In order to achieve true *and fair* presentation, the proceeds of the issued **compound** financial instrument must initially be **split** into two components each **presented separately** in the SFP according to their separate characteristics:

A. A **financial liability** component: represents **obligation** to **pay** interest *and* **repay** the principal in cash;

B. An **equity** component: represents the *written call option* to **convert** the instrument into fixed number of the issuer's ordinary shares.

Illustrative example: How should an issued convertible **debt** initially recoded?

- A. It should be **presented** solely as **debt**. B. It should be **presented** between **debt and equity**.
C. It should be **presented** solely as **equity**. D. It should be **presented** as part **debt and** part **equity**.

Answer (D) is correct.

2. Under **split accounting** the **liability and equity** components of the issued **compounded** financial instrument should be **accounted for** based on their substance because the **equity portion** *although* **embedded option** to **convert** the **liability** into **ordinary shares** of the issuer *but* this option should assigned a value on **initial recognition** *even when* it subsequently become out of the money.

Notes:

A. Usually the proceeds from **convertible debt** exceed the proceeds of similar **debt without** a **conversion option** because it includes an **embedded** value of **conversion feature** to the bondholder.

B. The **conversion feature** of **convertible debt** can't be separately traded *while* a detachable share warrant attached to the issued **debt** instrument can be separately traded.

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2/3. Initial recognition of a compound instrument

Initially the issued **compound** instrument must be **split** into a **liability** component *and* an **equity** component using '**with-and-without approach**' (residual value method) as follows:

1. The **liability** component is **first measured** at its **F.V** where the **F.V** of the **liability** component is the **P.V** of the future interest *and* principal payments discounted at market interest rate of similar **debt** instrument *without* conversion right.

Subsequently the **liability** component is **measured** under IFRS Accounting Standard # 9 either at **amortised cost** using an effective interest rate *or* **F.V** through **P/L**.

♦ If the **debt** instrument is **converted** to the issuer's **ordinary shares**; its carrying amount at the **conversion date** is transferred to **equity** with no **G/L** is **recognised** in **P/L**.

2. The **equity** component (the allocated value of detachable **warrant** *or* the **convertibility feature**) represents the difference between the full **proceeds** *and* the **P.V** of the **liability** component.

Subsequently the **equity** component is **not re-measured** (*regardless* of the likelihood of exercising the **conversion option**) *rather* it is carried at the **initially recognised** amount *until* **conversion** *or* the **conversion period** expires. At that time, the **equity** element is treated as a **share option premium** (*or* any **non-distributable reserve** within **equity**).

Note: An instrument that 'from the issuer's perspective' has both **liability** *and* **equity** elements is generally 'from the holder's perspective' is a **financial asset** that contains **embedded derivative**.

3. Issuance price (**F.V**) of any **non-convertible bond** is the **P.V** of all interest *and* principal payments discounted at market interest rate (yield) prevailing at issuance date.

4. The issuance price of a **debt instrument** can be as follows;

Case	Relation between issuance price <i>and</i> face value
If nominal interest rate = Market interest rate	Issuance price = Face value; issuance at face
If nominal interest rate < Market interest rate	Issuance price < Face value; issuance at discount
If nominal interest rate > Market interest rate	Issuance price > Face value; issuance at premium

5. The issuance of **convertible bond** gives the bondholder an **advantage** (**option** to **convert** the **bond** into **share**). *Thus*; the stated interest rate on such **bond** is **normally lower** than a similar **bond** *without* **conversion option**.

Illustrative example: Assume 5,000 convertible bonds were issued by Needy on 1, Jan, 2018 with the following terms:

- ♦ The bonds are due 31, Dec 2019;
- ♦ Issuance price is at nominal value (face value /notional amount) \$1,000 each;
- ♦ Semiannual interest is due in arrears at an annual nominal rate (stated rate/coupon rate) 5%;
- ♦ Each \$1,000 face amount bond is convertible into 150 ordinary shares of Needy (fixed number);
- ♦ At issuance date similar non-convertible debt must yield 8%.

Required:

- A. Allocate the proceeds of the convertible bonds into its components.
- B. Account for the bond under the amortised cost method.
- C. Assume the bondholder converted the bond on 31, Dec, 2019 when the F.V of Needy's ordinary share was \$8 and its par value is \$2.
- D. Assume the F.V of Needy ordinary share was \$6 on 31, Dec 2019.

Answer:

A. Allocation of the convertible bond proceeds:

The issued convertible bond is a compound financial instrument. Under IAS # 32; residual value method is required to split the proceeds of \$5m (5,000 bonds × \$1,000) to two components; the issuer must first assign a portion of the proceeds to the liability component based on F.V (P.V) of the debt component with the residual being assigned to the equity component.

♦ P.V of similar bond without convertibility feature can be determined by discounting all future semiannual interest payments calculated at nominal interest rate (5,000 bonds × \$1,000 × 5% × ½ = \$125,000) and principal bond redemption (\$5m) all are discounted using market interest rate prevailing at the issuance date (8% × ½ = 4% semiannual)

$$\text{♦ Liability component} = \frac{\$125,000}{(1+0.04)^1} + \frac{\$125,000}{(1+0.04)^2} + \frac{\$125,000}{(1+0.04)^3} + \frac{\$5,125,000}{(1+0.04)^4} = \$4,727,758 \text{ (assumed to be the F.V of a similar}$$

bond without convertibility option).

Note: Because the effective interest rate used in discounting (market interest rate) is higher (8%) than the stated rate (5%), the P.V of the bond will be lower than face value.

General rule: as effective interest rate used in discounting future cash flow increases, the P.V decreases.

$$\text{♦ Equity component (residual)} = \$5\text{m} - \$4,727,758 = \$272,242$$

♦ Initial allocation of the compounded instrument (convertible bond) proceeds would be recorded as follows:

Dr: Cash \$5,000,000

Cr: Bonds payable \$4,727,758 → non-current liability

Cr: Option to acquire ordinary shares \$272,242 → equity

Notes:

♦ It is not appropriate to determine the F.V of the **equity** component first *and then* allocate the residual to the **liability** component because **equity** is the residual interest in assets after deducting all **liabilities**.

♦ The amount allocated to the **bond** component \$4,727,758 is less than its face value \$5m because market rate (8%) on similar **bonds without conversion option** is higher than the nominal interest rate 5%. Thus; the **bond** is issued at **discount** \$272,242 (which equals the amount allocated the **equity** component).

♦ The **split** between the **liability** and **equity** components remains the same *throughout* the term of the **bond** *even if* there are changes in the likelihood of the **option** being exercised because it is not always possible to predict how the **convertible bond** holder will behave. The issuer continues to have an **obligation** to make future **payments until conversion** or maturity of the **bond**.

B. Measuring the **liability** component under effective interest rate as it is carried at **amortised cost**

Issuance date	30, June, 2018	31, Dec, 2018	30, June, 2019	31, Dec, 2019	Total
Dr: Finance cost (P/L)	\$189,110*	\$191,675**	\$194,342	\$197,115	\$772,242
Cr: Cash	\$125,000	\$125,000	\$125,000	\$125,000	500,000
Cr: Bonds payable	\$64,110	\$66,675	\$69,342	\$72,115	272,242
Bonds payable balance at each period-end under amortised cost	4,791,868	4,858,543	4,927,885	5,000,000	

Under **amortised cost** method:

- **Finance cost** is calculated based on **market** interest rate.

- **Cash paid** is **always** based on **contractual** (nominal/ coupon or explicit) interest rate $\$5m \times 5\% \times \frac{1}{2} = \$125,000$.

- The difference between the semiannual finance cost *and* semiannual cash payments **increases** the **bond balance** *until* the **bond** carrying value at maturity date equals its face value of \$5m.

$$* \$4,727,758 \times 8\% \times \frac{1}{2} = \$189,110$$

$$** \$4,916,868 \times 8\% \times \frac{1}{2} = \$191,675$$

C. Conversion of **bonds** to ordinary shares:

♦ Number of **ordinary shares** = 5,000 **bonds** $\times$ 150 **ordinary share per bond** = 750,000 **shares**.

♦ F.V of shares at 31, Dec, 2019 = 750,000 shares $\times$ \$8 = \$6m > face value of the **bonds**, the bondholders are motivated to convert the **bonds** to **shares**.

♦ Journal entry to **record conversion** in Needy accounts:

Dr: **Bonds payable** \$5m

Cr: **Share capital** (750,000 shares $\times$ \$2 par value) = \$1.50m

Cr: **Share premium** (\$5m - \$1.50m) = \$3.50m

Because the **option** to acquire **ordinary shares** has been exercised, the amount allocated **initially** to that **option** can be closed to other component *within equity such as 'share option premium'* as follow:

Dr: Option to acquire ordinary shares \$272,242

Cr: Share option premium \$272,242 (or any non-distributable reserve *within equity*)

D. Redemption of bonds:

♦ F.V of shares at 31, Dec, 2019 = 750,000 shares × \$6 = \$4.50m < face value of the **bonds**, the bondholders are motivated to receive the face value.

♦ Journal entry to record **bonds redemption** in Needy accounts:

Dr: **Bonds payable** \$5m

Cr: Cash \$5m

Because the **option** to acquire **ordinary shares** has been elapsed, the amount allocated **initially** to that **option** can be closed to other component *within equity such as 'share option premium'* as follow:

Dr: Option to acquire ordinary shares \$272,242

Cr: Share option premium \$272,242 (or any non-distributable reserve *within equity*)

6. **Induced conversion of debt instrument**

Any sweetener offered by the **debt issuer**, *such as* reducing **conversion prices** *or* promising **additional** consideration to **induce** conversion of the outstanding **convertible debt** to avoid overhanging **debt** is treated as a **reduction in equity** when **debt** is converted.

Illustrative example: From the previous illustrative example *when* the F.V of Needy **ordinary share** was \$6 on 31, Dec, 2019 the bondholders will **not** be motivated to **convert** the **bonds** to **ordinary shares** because total F.V of the shares would only be \$4.50m (as shown above). Assume Needy would pay \$600,000 *if* the bondholders choose to **convert**. *In such case* the bondholders will be induced for **conversion** because they will receive total consideration of \$5.10m (\$4.50m in shares + \$0.60m cash). The **conversion** would be recorded by Needy as follows:

Dr: **Bonds payable** \$5m

Cr: Cash \$0.60m

Cr: **Share capital** (750,000 shares × \$2 par value) = \$1.50m

Cr: **Share premium** (\$5m - \$1.50m - \$0.60m) = \$2.90m (*instead of* \$3.50m)

7. Accounting for issuance costs of compounded financial instrument

A. Issuance costs are allocated in proportion to the initial values assigned to the liability and equity components.

B. Issuance cost related to debt component is initially deducted from the debt component **if** the debt component is subsequently measured at amortised cost. While issuance cost related to debt component subsequently measured at F.V through P/L, is expensed to P/L.

C. Issuance cost related to equity component is initially deducted from equity component in all cases because it is not re-measured until debt maturity or conversion.

Illustrative example (1): On 1, Oct, 2018 Epsilon issued 5m loan notes that had a value of \$1 per note. The issue costs were 3 cents per note. Each note holder will receive interest of 5 cents per note on 30, Sep of each year starting on 30, Sep, 2019. The loan notes are repayable on 30, Sep, 2028 at \$1.20 per note. As an alternative to repayment, the loan note holders can elect to exchange their notes for a predetermined number of Epsilon's ordinary shares. On 1, Oct, 2018 the credit rating of Epsilon was such that it would have had to offer investors in non-convertible loan notes a rate of return of 9% per annum on any investment. The impact of issue costs would increase the effective interest rate on such loan notes to 9.45%.

The following information regarding discount rates may be relevant.

Discount rate	P.V of \$1 at the end of 10	Cumulative P.V of \$1 receivable at the end of years 1 to 10
	Lump sum	Annuity
5%	61 cents	\$7.72
9%	42 cents	\$6.42

Required: Prepare extracts from the F/S' for the year-ended 30, Sep, 2019. Your extracts should be supported by appropriate explanations.

Answer:

1. The issued loan note is a compounded financial instrument because it can be converted to the issuer's shares. Thus; according to provisions of IAS # 32 'Financial instruments presentation' the proceeds should be allocated between debt component and equity component.

2. Allocation of the \$5m proceeds between debt and equity;

A. F.V of loan note is the P.V of future annual cash payments of interest and principal redemption at the end of year 10 all discounted at prevailing interest rate at inception.

B. The principal redemption occurs at a point in time. Thus; use P.V of a lump sum discounted at yield (9%); where N = 10 periods because redemption is at the end of ten years.

C. The amount redeemable of the principal is 120% of its face value (redemption is at a premium)

D. The interest payments occur over 10 years. Accordingly use P.V of an annuity discounted at yield (9%); where N = 10 periods.

F.V of loan note = (\$5m face × 120% principal redemption premium × \$0.42) + (\$5m × 5% × \$6.42) = \$4,125,000.

E. Equity component is allocated the residual = \$5m - \$4,125,000 = \$875,000.

3. Issuance cost (cost born by the issuer to register and market the loan notes) = \$5m × 3% = \$150,000.

4. Issuance cost should initially reduce both debt component and equity component proportionately as follows:

Component	Gross amount allocated	%	Issuance cost allocation	Net component initial amount
Debt	\$4,125,000	82.50%	(\$123,750)	\$4,001,250
Equity	875,000	17.50%	(26,250)	848,750
Total	5m	100%	(150,000)	4,850,000

5. Recording issuance of **loan note**:

Date	Description	Dr	Cr
1, Oct, 2018	Dr: Cash (\$5m - \$150,000 issue cost) Cr: Loan note Cr: Option to acquire ordinary shares (Recording issuance of 5m convertible loan note)	\$4,850,000	\$4,001,250 \$848,750

6. Finance cost would be calculated based on adjusted market interest rate for issue cost. *Thus*; finance cost would be calculated based on 9.45% *rather than* 9%.

Date	Description	Dr	Cr
30, Sep, 2019	Dr: Finance cost (\$4,001,250 × 9.45%) Cr: Cash (\$5m × 5%) Cr: Loan note (\$378,118 - \$250,000) (Recording finance cost under effective interest method)	\$378,118	\$250,000 \$128,118

Notes:

A. *While* market interest rate was 9% *but* the **effective interest rate** used to calculate finance cost was 9.45% because **issuance cost** was deducted from the **liability** component. That rate would exactly discount the estimated future cash payments through the expected life of the **debt** to the **net reduced carrying amount** of the **loan**. This rate is called **internal rate of return**. *Thus*; effective interest rate sometimes could be slightly **higher** than yield.

B. The effective interest rate is the **internal rate of return** that equates net proceeds from the issued **financial liability** with the **discounted** cash flows of future interest *and* principal repayments.

C. As a general rule, the carrying value of **financial liabilities** held under **amortised** is determined using the effective interest rate.

Extract from F/S'

Statement of P/L

Finance cost \$378,118 (non-operating cost)

Equity

Option to acquire ordinary shares \$848,750.

Non-current liability

Loan note \$4,001,250 + \$128,118 = \$4,129,368.

Explanation and calculations

Under the provisions of IAS # 32 'Financial instruments-presentation'; the loan needs to be split into its liability and equity components. The liability component is the P.V of the future cash outflows discounted at 9% this would equal \$4,125,000. The equity element is therefore the residual \$875,000. Both the above amounts are before accounting for the issue costs of \$150,000. These should be allocated to the liability and equity components in the ratio 82.50% and 17.50%. This means that \$123,750 is allocated to the liability component and \$26,250 to the equity component. Therefore the initial liability component after allocating the issue costs is \$4,001,250 and the initial equity component is \$848,750. The equity component will be unchanged over the life of the instrument but the liability component will be measured at amortised cost using an effective interest rate of 9.45%. The

Finance cost for the year-ended 30, Sep, 2019 will be \$378,118 and the closing liability \$4,129,368.

Illustrative example (2): On 31, Oct, 2018 Gandy issued 1,000 convertible bonds with a maturity of five years.

Each bond has a face value of \$100,000 a stated interest rate is 5% per year and is convertible into 5,000 of Gandy's ordinary shares (fixed number). The convertible bonds are issued at face. The per-share price for the entity's share is \$15. Quotes for similar bonds issued by the entity without a conversion option (i.e., bonds with similar principal and interest cash flows) suggest that they can be sold for \$90,000 per bond.

Required:

1. Indicate how Gandy should account for the compound instrument on initial recognition.
2. Determine whether the effective interest rate will be higher, lower or equal to 5%.

Answer: Gandy should separate the liability and equity components of the convertible bonds using the with-and-without method.

A. F.V of the liability component equal \$90,000 per bond because similar bonds without an equity component sell for that amount. Accordingly the initial carrying amount of the liability component is \$90m.

B. Initial carrying amount of the equity component equal the difference between the total proceeds received \$100m and the initially allocated amount to the liability component of \$90m.

Dr: Cash \$100m

Cr: Bonds payable \$90m

Cr: Option to acquire shares-equity \$10m

Note: The effective interest rate is higher than 5% because it includes amortisation of the difference between the initial carrying amount of the liability component of \$90m and the principal amount of the liability of \$100m.

The effective interest rate is 7.70%. Determined under trial and error method as follow (out of the exam scope)

3) Discretionary dividends paid are debited to R.E^s just as any dividends paid on an equity security.

Illustrative example: Rambo issued 5% non-cumulative P.S that is **redeemable** for \$1,000 cash after 5 years. It pays dividends **only** at the **discretion** of the issuer (Rambo). Assume the prevailing interest rate of a similar instrument at the issuance date was 6%.

Required: Determine *whether* the above P.S a **compound instrument**.

Answer: The P.S is a **compound instrument** *where* the contractual **obligation** to **redeem** the principal amount at the end of the term is a **liability** and the difference is **recognised** as **equity**.

The **liability** component is initially **recognised** at the **P.V** of the **redemption** amount (**P.V** of \$1,000) discounted at interest rate of a similar instrument. The unwinding of the **discount** on the **liability** component is **recognised** as **finance cost** in the statement of **P/L**.

P.V of the contractual **obligation** to **redeem** the principal amount = $\frac{\$1,000}{(1+0.06)^5} = \747 .

Dr: Cash \$1,000

Cr: P/S-**liability** \$747 → corresponds to the **redemption obligation** feature

Cr: **Other components of equity** (\$1,000 - \$747) = \$253 → corresponds to the **non-cumulative** feature

Description	Year-end				
	(1)	(2)	(3)	4	5
Dr: Finance cost (P/L)	\$44.82	\$47.51	\$50.36	\$53.38	\$56.93
Cr: P/S- liability	44.82	47.51	50.36	53.38	56.93
Finance cost calculation	747 × 6%	791.82 × 6%	839.33 × 6%	889.69 × 6%	943.07 × 6% = 1,000
Liability balance at year-end	791.82	839.33	889.69	943.07	1,000

At redemption date:

Dr: P/S-**liability** \$1,000

Cr: Cash \$1,000

Thus, the **liability** component of this financial instrument is *considered as if* an **interest free loan** (**zero coupon bond** with a maturity of 5 years and a **redemption** amount of \$1,000 at maturity).

Because an interest free **liability** is an **off-market instrument**, the **F.V** of the **liability** component is discounted to **P.V** using an interest rate of a similar instrument (6%). The difference between the issuance proceeds of \$1,000 and the **P.V** of the **liability** component is the **equity** component (\$253).

Note: The P/S holder would still expect some dividend payments *although* these are not contractually mandated to be paid. In any year dividends are paid, the issuer will record the following entry

Dr: R.E^s \$50 → like any dividends payment on an **equity instrument**

Cr: Cash \$50

Also note: *If* the issued P.S is **cumulative** *then*, **no equity** component exists.

Also note: If the issued P.S is **cumulative** then; no **equity** component exists.

Focus points

1. Interest **paid**, dividends **paid**, **G/L** associated with changes in F.V and **G/L** associated with **redemption** of **financial liability** or component part thereof **all** are recognised in **P/L**.
2. Dividends **paid** on **financial instrument** classified as **equity** reduces **equity** (R.E^s) and reported in the statement of changes in equity.
3. No **G/L** is recognised in **P/L** on the entity's transactions with its equity holders at their capacity as owners *such as* issuance, repurchase, reissuance *or* cancellation of the entity's own **equity instruments**. Consideration received *or* paid is directly recognised in **equity**.
4. Treasury shares are *either* **presented separately** as a contra **equity** account in the SFP *or* disclosed in notes.
5. Changes in F.V of the entity's **equity** are not recognised in F/S^s.
6. Transaction costs incurred in issuing *or* acquiring of **equity** instruments reduces share premium *within* **equity**.

الأدوات المالية المركبة (الهجينة) (المحاسبة المنقسمة وفقاً للمعيار الدولي لإعداد التقارير المالية رقم 32)

2/4. Offsetting financial assets and financial liabilities

1. It is **inappropriate** to offset financial assets *and* financial liabilities. Separate presentation in the SFP better reflects the entity's expected future cash flows *and* associated risks.
2. Per IAS # 32 an entity can **only** offset financial assets *and* financial liabilities *when and only when* it;
 - A. Has legally enforceable right to set them off, *and*
 - B. Intends *either* to settle on net basis *or* to realise the asset *and* settle the liability simultaneously.

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2/5. The impact of IAS # 32 classification

1. **Financial liabilities** increase gearing *and risks* to potential investors, also finance cost will be charged to **P/L** which reduces profits.
2. Issued **equity** instruments **reduce** gearing, *also* amounts paid on **equity** instrument directly reduces **equity** *and* will not impact profit.

2/6. Disclosure requirements under IAS # 32

All disclosure requirements were removed from IAS # 32 and placed in IFRS Accounting Standard # 7.

3/1. Overview

1. **Loans** issued are **accounted for** under IAS # 32 '**Financial Instruments-Presentation**' and IFRS Accounting Standard # 9 '**Financial instruments**'
2. Any **accounting treatment** in contrary to the above standards should be corrected *and* reflected in consolidated F/S' as *such*.
3. Adjustments related to the parent affect only the parent *while* adjustments related to the affects both the parent *and* NCI.

3/2. Issued **debt** instrument that inappropriately classified as **equity**

Illustrative example: On 1, April, 2019 the parent issued 15m P/S^s at its par of \$1.

The proceeds were credited to **equity**. The shareholders will not receive a dividend *but* the shares are **redeemable** on 31, March, 2023 for \$1.61 per share. This is equivalent to an annual return of 10% for the shareholders.

Required: Show the effects on consolidated F/S^s for the year-ended 31, March, 2020.

Answer: According to IAS # 32 'Financial instrument-presentation'; the **redeemable** P/S^s are initially classified as a **liability**.

Finance cost on P/S^s = \$15m × 10% = \$1.50m

Description	Consolidated P/L	Consolidated SFP
Reclassifying P/S ^s as a liability	No effect	Dr: Equity-P/S \$15m Cr: Long term liability -P/S ^s \$15m
Recording finance charge	Dr: Finance cost- Parent \$1.50m Cr: Long term liability -P/S ^s \$1.50m	Dr: R.E ^s \$1.50m Cr: Long term liability -P/S ^s \$1.50m

3/3. Issued **compounded** financial instrument that **inappropriately**

Classified as debt instrument

Illustrative example (1): On 1, April, 2019 the parent issued \$30m 6% **convertible loan note** at par. The **loan note** is **redeemable** at a **premium** of 10% on 31 March 2023 *or* it may be **converted** into **ordinary shares** on the basis of 50 shares for each \$100 of **loan note** at the **option** of the holder. The interest rate for an equivalent **loan note** *without* the **conversion rights** would have been 10%. In the draft F/S^s the parent has paid and charged interest of \$1.80m *and* the **loan note** was shown at \$30m on the parent's separate SFP.

The **P.V** of \$1 receivable at the end of each year based on discount rates of 6% and 10% can be taken as:

End of year	6%	10%
1	0.94	0.91
2	0.89	0.83
3	0.84	0.75
4	0.79	0.68
Total	3.46	3.17

Required: What is the **adjusting effect** on the consolidated F/S^s for the year-ended 31, March, 2020?

Answer:

1. Equity component of the **convertible liability**:

Description	Subtotal	Total
Amount recorded to loan payable		\$30,000
P.V of lump sum discounted at 10% (\$30,000 par value × 110% × P.V factor 0.68)	(22,440)	
Add: P.V of interest payments (\$30,000 × 6% × P.V factor of annuity 3.17)	(5,706)	
Debt component		(28,146)
Equity component of convertible bond		1,854

2. Finance cost based on effective rate = \$28,146 × 10% = **\$2,814.60**.

3. **Discount amortisation** = \$2,814.60 - \$1,800 = **\$1,014.60**.

Description	Consolidated P/L	Consolidated SFP
Recording equity component	No effect	Dr: Loan payable \$1,854 Cr: Other component of equity-Parent \$1,854
Recording discount amortisation	Dr: Finance cost- Parent \$1,014.60 Cr: Loan payable \$1,014.60	Dr: R.E ^s \$1,014.60 Cr: Loan payable \$1,014.60

Note: The **loan** balance at 31, March, 2020 in the consolidated SFP = \$28,146 + \$1,014.60 = **\$29,160.60**.

Illustrative example (2): The long-term borrowings of the parent include a **loan** at a carrying amount of \$60m which was taken out on 1, Oct, 2018. The **loan** does not carry any interest *but* \$75.60m is repayable on 30, Sep, 2021. This represents an effective annual rate of return for the investors of 8%. As an alternative to repayment, the **investors can** exchange their **loan asset** for **equity shares** in the **parent** on 30, Sep, 2021. The annual rate of return required by such investors on a **non-convertible loan** would have been 10%. The parent has not charged any finance cost in respect of this **loan** for the year-ended 30, Sep, 2019.

The **P.V** of \$1 payable/receivable in three years' time is as follows:

-79.40 cents *when* the discount rate is 8% per annum;

-75.10 cents *when* the discount rate is 10% per annum.

Required: What is the **adjusting effect** on the consolidated F/S^s for the year-ended 30, Sep, 2019?

Answer:

1. Equity component of the convertible liability:

Description	Amount
Amount recorded to loan payable	\$60m
Less: P.V of the loan assuming no conversion rights (\$75.60m × 0.751)	\$56,775,600
Equity component of convertible bond	3,224,400

2. Finance cost based on effective rate = \$56,775,600 × 10% = \$4,542,048.

Description	Consolidated P/L	Consolidated SFP
Recording equity component	No effect	Dr: Loan payable \$3,224,400 Cr: Other component of equity - Parent \$3,224,400
Recording discount amortisation	Dr: Finance cost- Parent \$5,677,560 Cr: Loan payable \$5,677,560	Dr: R.E ^s \$5,677,560 Cr: Loan payable \$5,677,560

Note: the **liability** balance at 30, Sep, 2019 in the consolidated SFP = \$56,775,600 × 110% = **\$62,453,160**.

Illustrative example (3): On 1, Oct, 2018 an 80% owned Sub issued 50m **loan notes** of \$1 each at par. The annual interest payable on these **notes** is 5 cents per **note payable** in arrears. The **notes** are **redeemable** at par on 30, Sep, 2023 *or* **convertible** (at the **option** of the note-holders) into **equity shares** on that date. On 1, Oct, 2018 investors in **loan notes** with no **conversion option** would have required an annual rate of return of 8%. On 1, Oct, 2018 the directors of the Sub included \$50m in long-term borrowings in respect of the **loan notes**. The actual interest paid of \$2.5m was charged as finance cost in Sub's statement of **P/L** for the year-ended 30, Sep, 2019.

Relevant discount factors are as follows:

Description	5%	8%
P.V of \$1 payable at the end of year 5	78.4 cents	68.1 cents
Cumulative P.V of \$1 payable at the end of years 1 to 5 years	\$4.33	\$3.99

Required: What is the adjusting effect on the consolidated F/S^s for the year-ended 30, Sep, 2019?

Answer:

1. Equity component of the convertible liability:

Description	Subtotal	Total
Amount recorded to loan payable		\$50,000
P.V of lamp sum discounted at 8% (maturity value \$50,000 × P.V factor 0.681)	34,050	
Add: P.V of interest payments (\$50,000 × 5% × P.V factor of annuity 3.99)	9,975	
Debt component		(44,025)
Equity component of convertible bond		5,975

2. Finance cost based on effective rate = $\$44,025 \times 8\% = \$3,522$.

3. Discount amortisation = $\$3,522 - \text{interest based on } 5\% \text{ is } \$2,500 = \$1,022$.

Description	Consolidated P/L	Consolidated SFP
Recording equity component	No effect	Dr: Loan payable \$5,975 Cr: Other component of equity-Parent $(\$5,975 \times 80\%) = \$4,780$ Cr: NCI $(\$5,975 \times 20\%) = \$1,195$ The equity component is allocated between the parent and NCI
Recording discount amortisation	Dr: Finance cost-Sub \$1,022 Cr: Loan payable \$1,022	Dr: R.E^s $(\$1,022 \times 80\%) = \817.60 Dr: NCI $(\$1,022 \times 20\%) = \204.40 Cr: Loan payable \$1,022

Note: the loan balance at 30, Sep, 2019 in the consolidated SFP = $\$44,025 + \$1,022 = \$45,047$.

1/1. Examinable syllabus guide for

December 2025 to June 2026 according to ACCA

IFRS # 9 – Financial Instruments

- Discuss and account for the initial and subsequent measurement of financial instruments including the business model and contractual cash flow tests
- Discuss and account for the subsequent measurement (including impairment in the case of financial assets) of financial assets and financial liabilities in accordance with applicable IFRS Accounting Standards.
- Discuss the conditions that are required for a financial asset or liability to be de recognised.

After studying our material and solving related questions, please refer back to the points above to make sure you fully cover it well.

1/2. General

Timing of financial instrument recognition

Due to significant **risks** that can arise from delayed **recognition** of financial instruments; IFRS **Accounting Standard # 9** follows an **accelerated approach** of financial instruments **recognition** in order to avoid misleading F/S^s users.

The general **recognition** principals per IFRS **Accounting Standard # 9** are as follows:

1. Financial assets and financial liabilities are recognised on the SFP *when* the entity **becomes a party to the contractual provisions** of the financial instrument *rather than* when the transaction is settled.

2. Firm commitments that are **financial** instruments *or* that are subject to **net settlement** *although* executory contract *but* are recognised on the commitment date as **financial asset/ financial liability**.

3. All changes in F.V of **financial derivative** contracts (**forward contracts, futures and options**) related to future purchase *or* sell of financial instruments are **immediately recognised** in F/S^s as **financial asset/ financial liability** with the corresponding G^s/L^s are **immediately recognised** in **P/L** .i.e. not *when* the item under the **derivative** contract is transferred from the seller to buyer *even though* the entity may have paid *or* received nothing on entering into the derivative.

4. Normally a firm commitment related to **non-financial item** would not be recognised as an **asset or liability** because it is an **executory contract** *unless* the contract is **onerous** as per IAS # 37 provisions.

But under **hedge accounting** provisions of IFRS **Accounting Standard # 9**; the entity would **recognise an asset or liability** for a firm commitment that is designated as a **hedged item** in **F.V hedge** to the extent there have been **changes** in the F.V of the firm commitment attributable to the **hedged risk** (explained later in detail). **Ex:** entering into a firm commitment to purchase inventory from foreign entity that is designated as a **hedged item** in a **F.V hedge** of the associated foreign currency **risk**.

5. Forecasted transactions *even though* it may be highly probable; they are **not** recognised as **financial asset/ financial liability** because the entity has not yet become a party to a contract. *Thus*; in the absence of any contractual **right or obligation** *there is no* financial asset/financial liability to recognise.

Initial measurements of financial assets and financial liabilities

1. Financial assets are measured at F.V of the consideration given (cost) *and* **financial liabilities** are measured at the F.V of the consideration received (proceeds).

Note: Quoted price in an active market is the best evidence of the F.V.

2. Transaction costs for financial instruments measured at **F.V** *through* **P/L** are immediately **expensed** in **P/L**.

Illustrative example: Napoleon purchased 100 shares of entity (B) with a quoted price of \$124 each. Napoleon incurs broker fees of \$100 to acquire the shares that are acquired for **trading**. Napoleon classifies these shares as at **F.V** through **P/L**.

Required: What is the **accounting treatment** of the transaction costs?

Answer: Transaction costs would be initially **expensed** as follows:

Dr: Financial assets \$12,400

Dr: Transaction costs \$100 → **P/L**

Cr: Cash \$12,500

Note: *if* Napoleon had carried the shares at **F.V** through **OCI**, transaction costs will be initially added the **financial asset**

Dr: Financial assets \$12,500

Cr: Cash \$12,500

3. Transaction costs for financial instruments **not** carried at **F.V through P/L** are initially added to **financial assets and deducted from financial liability**.

Illustrative example: Robin issued **bonds** for \$17,100 and incurred issuance cost of \$300.

Required: How the transaction cost is accounted for *if* the **bonds** are measured at **amortised cost**?

Answer: Issuance cost will initially be deducted from the **financial liability** because **bonds** are measured at **amortised cost**.

Dr: Cash \$16,800

Cr: bonds payable \$16,800

Note: *If* the **bonds** are measured at **F.V through P/L**; transaction costs would be initially **expensed** as follows:

Dr: Cash \$16,800

Dr: Issuance costs \$300 → **P/L**

Cr: Bonds payable \$17,100

2/1. Overview

Initial measurement and recognition

1. **Financial liabilities** are recognised *when* the entity becomes a party to the contractual provisions of the instrument.
2. **Financial liabilities** are initially measured at the F.V of the consideration received.
- A. *If* the **financial liability** subsequently measured at **amortised cost**; transaction costs are initially deducted from the carrying amount of the **financial liability**.

Illustrative example: Todd issued 500 **bonds** \$1,000 nominal at 105. Interest rate is 10% *and* the **bond** issuance cost was \$15,000 assume the **bonds** would be measured at **amortised cost**.

Required: Calculate the initial amount assigned to the **bonds**.

Answer: $(500 \text{ bond} \times \$1,000 \times 105\%) - \$15,000 = \$510,000$

- B. *If* the **financial liability** subsequently measured at F.V *through* **P/L**; transaction costs are initially **expensed**.

Subsequent measurement

Under IFRS Accounting Standard # 9 **financial liabilities** are **subsequently** measured at *either*:

1. **Amortised cost** using effective interest method (**mostly**); *or*
2. **F.V through P/L** (for **financial liabilities** held for trading *and* derivatives).

Notes:

- A. *When* the **financial liability** is measured at F.V *through* **P/L** the resulting **G/L** on F.V re-measurement is recognised in **P/L**, also **impairment loss** *and* foreign currency **G/L** are recognised in **P/L**.
- B. F.V accounting for **financial liabilities** was *and* remains controversial topic.
- C. *Where* F.V can't be reliably measured; the **financial liability** should be measured at **amortised cost**.

2/2. Amortised cost

1. Most financial liabilities are subsequently measured at **amortised cost** using effective interest method.

2. The effective interest rate used to discount future interest *and* principal payments would be **higher** than the nominal rate *if* the **debt** instrument is issued at **discount or redeemed** at **premium** than its face value;

Illustrative example: Metro issued five years **bond** of \$10m nominal value at \$9m interest is **payable** annually in arrears at 10% the **bonds** would be **redeemed** at \$12m. Assuming issuance cost is \$300,000.

Required:

A. Calculate the amount **initially recognised** *if* the **bond** would be carried at **amortised cost** *and* record the **initial issuance** of the **bond**.

B. Determine *whether* the effective interest rate is higher *or* lower than nominal rate.

Answer:

A. **Initial** carrying amount of a **financial liability measured** at **amortised cost** = Issuance price \$9m - transaction costs \$0.30m = \$8.70m

Dr: Cash \$8.70m

Cr: **Bonds payable** \$8.70m

B. Because the **redeemable** amount of \$12m is higher than the net issuance price (\$8.70m). *Then* a **higher** effective rate than 10% is needed to arrive at the maturity value of \$12m.

Note:

♦ The effective interest rate is the **internal rate of return** that equates net proceeds from the issued **financial liability** with the **discounted** cash flows of future interest *and* principal repayments.

♦ Straight line amortisation method is **not** allowed.

3. Conversely the effective interest rate used to discount future interest *and* principal payments would be **lower** than the nominal rate *if* the **debt** instrument is issued at **premium or redeemed** at **discount** than its face value;

4. The effective interest rate used to discount future interest *and* principal payments would **equal** the nominal rate *if* the **debt** instrument is issued *and* **redeemed** at face.

5. Calculating proceeds from debt issuance:

Proceeds from **debt** issuance = [(Periodic interest payments × **P.V** factor for an annuity discounted at **yield**) + (**Redemption** value × **P.V** factor for lump sum discounted at **yield**)].

Note: *Although* interest **payment** is calculated based on stated interest rate *but* all future cash payments (interest *and* principal) are discounted based on market interest rate prevailing at issuance date.

Illustrative example: Young issued \$800,000 of 10% **bonds** at 1, Jan, 2018. Interest is **payable** semiannually on 30, June and 31, Dec. The **bonds** mature in 5 years. The current market for similar **bonds** is 8%.

The following values are given;

Description	P.V of an annuity	P.V of \$1 (lump sum)
N=10, I = 4%	8.11090	0.67556
N=10, I = 5%	7.72173	0.61391

Required: Calculate the amount of proceeds on the **bond** issuance.

Answer:

Semiannual interest payments = $\$800,000 \times 10\% \times 1/2 = \$40,000$; discounted at 4% semiannual annuity for 10 periods.

Principal \$800,000 is discounted at 4% as lump sum after 10 periods.

Proceeds = $[(\$40,000 \times 8.11090) + (\$800,000 \times 0.67556)] = \$864,884$

Debt issuance situations

1. Issuance at discount

Illustrative example (1): On 1, Jan, 2018 James issued **loan note** with \$50,000 nominal value at 16% discount. The issuance cost was \$2,000 and 5% annual interest is **payable** in arrears. The **bond** must be **redeemed** on 1, Jan, 2023 at a **premium** of \$4,611. The effective rate of interest is 12%.

Required: How will this **loan note** be reported in F/S^s of James over the period to **redemption** assuming the **liability** will be measured at **amortised cost**?

Answer:

1. Calculating initial amount of the **financial liability:**

The **loan note** will be **initially recognised** at the net proceeds received as follows;

Description	Amount
Face value	\$50,000
Less: 16% discount	(8,000)
Less: Issue costs	(2,000)
Net proceeds	40,000

Dr: Cash \$40,000

Cr: **Loan note payable** \$40,000

2. Recording finance cost:

Entries	Year-end						Total
	Issuance date	2018	2019	2020	2021	2022	
Dr: Finance cost (P/L)		\$4,800*	\$5,076**↑	\$5,385↑	\$5,731↑	\$6,119↑	\$27,111
Cr: Cash		2,500	2,500	2,500	2,500	2,500	(12,500)
Cr: Loan note payable		2,300	2,576↑	2,885↑	3,231↑	3,619↑	14,611
Loan balance	40,000	42,300	44,876↑	47,761↑	50,992↑	54,611↑	
The effective interest rate achieves constant rate in each period over the life of the financial liability → 12%							

*\$40,000 × 12% = \$4,800.

**\$42,300 × 12% = \$5,076.

Note: as a general rule interest paid = face value of the **loan** × nominal interest rate *regardless of whether the liability is issued or redeemed at discount or premium*.

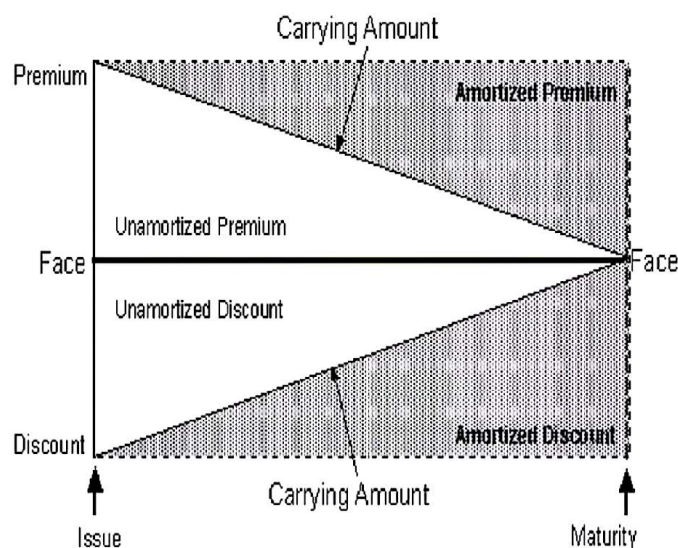
3. Loan note redemption:

Dr: **Loan note payable** \$54,611

Cr: Cash \$54,611

4. Analysis of the loan note costs:

Description	Amount
Discount	\$8,000
Issuance costs	2,000
Redemption premium	4,611
Interest paid (\$2,500 × 5 years)	12,500
Total recognised finance cost under effective rate method over the loan term	27,111



Notes

A. The finance cost annually recognised in P/L > actual interest paid. Thus, the carrying value of the liability increases over the life of the instrument until it equals the redemption amount at maturity date.

B. During years from 1 to 4; the liability would be presented in the SFP as a non-current liability and would be reclassified as a current at the end of the fourth year.

C. During years from 1 to 4; the liability balances in the SFP < the redeemable amount. Therefore the full amount redeemable must be disclosed in the notes to the F/S⁵.

D. F.V information for liabilities measured under amortised cost is irrelevant.

E. If the financial liability is repaid (repurchased) before its maturity; extinguishment G/L will result if the repurchase price is different from the carrying amount this G/L is recognised in P/L.

For example assume at 31, Dec, 2020 James reacquired and writes off the loan at either \$46,000 or \$48,000.

What are the required entries?

Reacquisition price	
\$46,000	\$48,000
Dr: Loan note \$47,761 Cr: Cash \$46,000 Cr: Redemption gain \$1,761 → (P/L)	Dr: Loan note \$47,761 Dr: Redemption loss \$239 → (P/L) Cr: Cash \$48,000

Illustrative example (2): Album issued 10 year \$200,000 debenture bonds (unsecured bonds) on Jan, 2. The bonds pay interest semiannually. Album uses the effective interest method to amortise bond premium and discounts. The carrying value of the bond on Jan, 2 was \$185,953. A journal entry was recorded for the first interest payment on 30, June debiting finance cost for \$13,016 and crediting cash for \$12,000.

Required: What is the annual stated interest rate for the debenture bond?

Answer: Annual stated interest rate = $\frac{\$12,000}{\$200,000} \times 2 = 12\%$.

Note: Effective interest rate = $\frac{\$13,016}{\$185,953} \times 2 = 14\%$.

2. Issuance at premium

Illustrative example (1): On 1, Jan, 2018 Denero issued bond with \$300,000 nominal value at \$325,782. The issuance cost was \$3,000. 12% annual interest is payable in arrears. The bond must be redeemed on 1, Jan, 2021 at face. The effective rate of interest is 9%.

Required: How will this bond be reported in F/S⁵ of Denero over the period to redemption assuming the liability will be measured at amortised cost?

Answer:

1. Calculating initial amount of the financial liability:

The bond will be initially recognised at the net proceeds received as follows:

Description	Amount
Total Proceeds	\$325,782
Less: Issue costs	(3,000)
Net proceeds	322,782

Dr: Cash \$322,782

Cr: Bonds payable \$322,782

2. Recording finance cost:

Entries	Dates				Total
	Issuance date	2018	2019	2020	
Dr: Finance cost (P/L)		\$29,050*	\$28,425↓**	\$27,743↓	\$85,218
Dr: Bonds payable		6,950	7,575↑	8,257↑	22,782
Cr: Cash		36,000	36,000	36,000	108,000
Loan balance	\$322,782	315,832↓	308,257↓	300,000↓	
The effective interest rate achieves constant rate in each period over the life of the financial liability → 9%					

*\$322,782 × 9% = \$29,050.

**\$315,832 × 9% = \$28,425.

Note: as a general rule interest paid = face value of the **loan** × nominal interest rate *regardless of whether the liability is issued or redeemed at discount or premium.*

3. Bonds redemption:

Dr: **Loan note payable** \$300,000

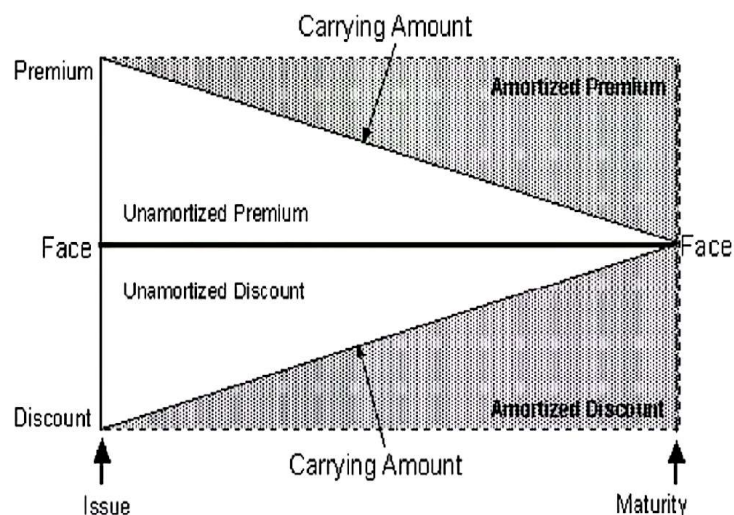
Cr: Cash \$300,000

4. Analysis of the loan note costs:

Description	Amount
Premium	(25,782)
Issuance costs	3,000
Interest paid (\$36,000 × 3 years)	108,000
Total recognised finance cost under effective rate method over the bond's term	85,218

Note

The finance cost annually recognised in P/L < actual interest paid. Thus; the carrying value of the **liability** decreases over the life of the **bond** until it equals the **redemption** amount at maturity date.



Illustrative example (2): If a **premium** on an issued **bond** is not amortised. Determine the effects on the following?

Choice	Finance cost	Equity
A	Overstated	Overstated
B	Understated	Overstated
C	Overstated	Understated
D	Understated	Understated

Answer (C) is correct:

3. Deep discount debt (Zero coupon debt)

When the **bond** is issued at a deep **discount**, no explicit interest is paid during the **bond** life. The implicit finance cost is the difference between the **redemption** amount and net proceeds.

Illustrative example: Galaxy issued **zero coupon bond** for \$503,778 on 1, Jan, 2018 (no explicit interest is payable) but it will be **redeemed** on 31, Dec, 2020 for \$600,000. The effective interest rate of the **bond** is 6%.

Required: How will this **bond** be reported in the F/S⁵ over the period to **redemption** assuming the **bond** is measured at **amortised cost**?

Answer: The **bond** is a 'deep discount bond' that it **measured at amortised cost**. Although there is no explicit interest; the difference between the **bond** proceeds and the **redemption** amount is finance cost that must be allocated over the term of the **bond** at a constant rate on the carrying amount.

Issuance:

Dr: Cash \$503,778

Cr: **Bonds payable** \$503,778

Entries	Year-end				Total
	Issuance date	2018	2019	2020	
Dr: Finance cost (P/L)		\$30,226.68*	\$32,040***	\$33,955.32	\$96,221.96
Cr: Bonds payable		30,226.64	32,040	33,955.32	96,221.96
Bond balance	\$503,778	\$34,004.68†**	\$66,044.68†	600,000†	
The effective interest rate achieves constant rate in each period over the life of the financial liability → 6%					

*\$503,778 × 6% = \$30,226.68.

** \$503,778 + 30,226.68 = \$534,004.68.

***\$534,004.68 × 6% = \$32,040.

Redemption:

Dr: **Bonds payable** \$600,000

Cr: Cash \$600,000

Revision (1): Sirius raised a **loan** with a bank of \$2m on 1, May, 2012. The bank *and* the market annual interest rate are 8% and the principal is to be repaid in ten years' time. The terms of the **loan** allow Sirius to redeem the **loan** after seven years by paying the interest to be charged over the seven year period **plus** penalty of \$203,031 **and** the principal of \$2m. The effective interest rate of the **repayment option** is 9.10%. The directors of Sirius are currently discussing the possibility of repaying the **loan** within the **next financial year**. Sirius is uncertain about the **accounting treatment** for the current **loan** agreement *and whether* the **loan** can be **presented** as a **current liability** because of the discussions with the bank.

Required: Discuss the principles *and* nature of the **accounting treatment** of the above under IFRS^s **Accounting Standards** in the F/S^s for the year-ended 30, April, 2018.

Answer: The bank **loan** is to be repaid in ten years time *but* the terms of the **loan** allows Sirius to pay it off in seven years. The issue arises *as to whether* the **early repayment option** is likely to be exercised.

If *when* the **loan** was taken out on 1, May, 2012 the **option of early repayment** was **not** expected to be exercised, *then;* at 30, April, 2018 the normal terms apply the **loan** would be stated at \$2m in the SFP *and* both the effective interest *and* the nominal interest would be \$160,000 ($8\% \times \$2m$).

If at 1, May, 2012 it was expected that the **early repayment option** would be exercised *then;* the effective interest rate would be 9.10% *and* the interest expense would be $9.10\% \times$ carrying amount of the **loan** at 1, May, 2017 which is higher than \$2m. The cash paid would still be \$160,000 *and* the difference would be added to the carrying amount of the **financial liability** giving **loan** balance of \$2,165,929 at 30, April, 2018.

Note: The carrying amount at the end of year 5 is \$2,131,924 *and* interest cost for year 6 would be \$194,005 ($\$2,131,924 \times 9.10\%$). *Thus;* the **loan** balance at the end of year 6 would be \$2,165,929 [$\$2,131,924 + (\$194,005 - \$160,000)$].

IFRS **Accounting Standard** # 9 'Financial instruments' require that; the carrying amount of a **financial asset or financial liability** should be **adjusted** to reflect actual cash flows *or* revised estimates of cash flows. This means that; *even if* it was thought at the outset that early repayment would not take place, *if expectations change;* the carrying amount must be revised to reflect future estimated cash flows using the effective interest rate.

Thus; if the carrying amount of the **loan** at the end of year 5 was \$2m; the interest cost that should be charged to P/L would be \$325,929 [$(\$2,165,929 - \$2m) + \$160,000$].

The directors of Sirius are currently discussing repayment in the next financial year *however* these discussions do **not** create a legal **obligation** to **repay** the **loan** in 12 months *and* Sirius has an **unconditional right** to defer settlement for longer than 12 months. *Accordingly* it would **not** be appropriate to present the **loan** as **current liability** on the basis of the discussions with the bank.

Revision (2): PQR has issued 100,000 **redeemable** P.S^s during 2018 at \$1 per share with an annual dividend payment of 6 cents per share. The shares are **redeemable** in 2022 at their nominal value.

Required: Advise the directors (*insofar as the information permits*) about the **accounting for the redeemable** P/S^s that are presented in its F/S^s for the year-ended 31, Dec, 2018 stating the effect on gearing of the entity. Your answer should be accompanied by calculations *where appropriate*.

Answer: **Redeemable** P.S^s *although* called shares *but* are **not** in substance **equity** they are **debt** instruments, i.e. a **loan** made to the entity which receives interest *and* is paid back at a later date. *Consequently* IAS # 32 requires them to be *classified as such* i.e. as a **non-current liability** in the SFP. The 'dividends' paid will be shown in **P/L** as **finance costs** *and* accrued at the end of the year *whether declared or not*. The shares are *consequently* a **financial liability** held at **amortised cost**. In this case the shares are issued *and* **redeemed** at face value. *Thus*; the effective interest rate *and* nominal coupon rate will be the same (6%) *and* each year \$6,000 will be shown as a **finance cost** in **P/L**. The balance outstanding under **non-current liabilities** at each year-end will be \$100,000 as follows:

Description	Amount	Comment
Beginning balance	\$100,000	Dr: Cash Cr: Non-current liabilities-P.S^s
Effective interest at 6%	6,000	Dr: Finance cost
Coupon paid (6% × 100,000)	(6,000)	Cr: Cash
Ending balance	100,000	Non-current liabilities-P.S^s

In the F/S^s for the year-ended 31, Dec, 2021, the shares will need to be reclassified as a **current liability** given that they will be repaid within one year.

♦ Given that these shares are classed as a **financial liability** gearing will be **higher** (as they are treated as **debt**) than *if* they were genuine shares which would be treated as **equity**.

2/3. F.V through P/L

Accounting treatment

1. The **financial liability** is initially recorded at gross proceeds *where* issuance costs are immediately recognised in **P/L**.
2. The **financial liability** is re-measured to **F.V** at each reporting date; **G/L** is recognised in **P/L**.

Cases when debt instrument is measured at F.V

Case (1): *If* the issuer intends to **trade** the **financial liability** in the short term.

Illustrative example (1): Loka issued 10 years **callable bond** 8% at face *when* the market interest rates were 8%. Shortly market interest rates **declined** to 5%.

Required: What is the appropriate **measurement** of the previous **bond** *if* Loka **initially** intended to **trade** it?

Answer: *When* the issued **bond** is **callable**, the issuer can call it back **before** maturity date *when* the market interest declines to save the differential interest of 3%. *Thus*; this **bond** is **measured** at **F.V** through **P/L** because Loka **initially** intended to **trade** it in order to benefit from short-term movements in interest rates *if* market interest rate decline.

Illustrative example (2): On 1, Jan, 2018 McGrath issued a **financial liability** instrument for its nominal value of \$10m *and* incurred \$0.20m issuance cost. Interest is **payable** at 5% in arrears. The **liability** is **repayable** on 31, Dec, 2020. McGrath **trades** its **financial liabilities** in **short-term**. At 31, Dec, 2018 market rates of interest have risen to 10%.

Required: Discuss the **accounting treatment** of the issued **financial liability** at 31, Dec, 2018 assuming **F.V** of the **liability** can't be observed from an active market.

Answer:

A. The **financial liability** is intended to be **traded** in **short-term**, *so* it is measured at **F.V** through **P/L**.

1, Jan, 2018:

Dr: Cash (\$10m - \$0.20m) = \$9.80m

Dr: Issuance cost \$0.20m → **P/L**

Cr: **Financial liability** \$10m

31, Dec, 2018:

Dr: Finance cost (\$10m × 5%) = \$0.50m → **P/L**

Cr: Cash \$0.50m

The **liability** must be re-measured to **F.V** at the reporting date.

Because **F.V** of the **liability** can't be observed from an active market, it can be calculated by **discounting** the future cash payments at market interest rate as follows;

$$\text{F.V of the liability at Dec, 31, 2018 is its P.V} = \frac{\$500,000}{(1+0.10)^1} + \frac{\$10,500,000}{(1+0.10)^2} = \$9,132,231.$$

Gain on liability reduction = \$10m - \$9,132,231 = **\$867,769**.

Dr: Financial liability \$867,769↓

Cr: Gain on financial liability \$867,769 → **P/L**

Thus; the **F.V** of the **financial liability** at 31, Dec, 2018 would be **\$9,132,231**.

Note:

IFRS Accounting Standard # 9 requires that any movement in **F.V** of **financial liability** that is measured at **F.V** through **P/L** is split into two components:

A. **G/L** resulting from **credit risk** (change of creditworthiness of the issuer) it represents the **risk** that the issuer of the **financial liability** defaults, this portion of **G/L** should be included in **OCI** and **not recycled** to **P/L**.

B. Other **G/L** resulting from the change in the **F.V** of the **financial liability** due to other factors such as changes in market interest rates is recognised in **P/L**.

Illustrative example: From the previous example assume that, the **F.V** of the **financial liability** at 31, Dec, 2018 is either \$9m or \$9.20m. What is the appropriate **accounting treatment** if the difference between the **P.V** and **F.V** is related to McGrath credit risk?

Answer:

If F.V \$9m
Dr: Financial liability \$1,000,000
Cr: Gain on financial liability \$867,769 → P/L decline in the financial liability due to other factors
Cr: Gain on financial liability decline due to increased credit risk \$132,231 → OCI *
If F.V \$9.20m
Dr: Financial liability \$800,000
Dr: Loss on financial liability due to reduced credit risk \$67,769 → OCI *
Cr: Gain on financial liability \$867,769 → P/L decline in the financial liability due to other factors

* Thus; improved creditworthiness (i.e. decrease in **credit risk** of the debtor) causes **loss** and deteriorating creditworthiness (i.e. increase in **credit risk** of the debtor) causes **gain**. Both are recognised in **OCI-equity** and not recycled to **P/L** when the **financial liability** is derecognised.

Case (2).
The entity has **initially elected** to measure the **financial liability** at F.V through **P/L**.

F.V option of measuring **financial liability** is permitted **only** upon **initial recognition** and is not reassessed.

F.V option of measuring **financial liability** is intended to eliminate or significantly reduce a **measurement or recognition inconsistency (accounting mismatch)** and providing more relevant information to F/S^s users.

Note: When **financial liability** is initially designated to be measured at F.V through **P/L** to reduce **accounting mismatch**, the **F.V** movement would not be split into portion related to change in **credit risk** and other changes in **F.V** but rather the total change in **F.V** is recognised in **P/L**.

Illustrative example: Bean regularly invests in **financial assets** that are measured at F.V through **P/L**. **Financial assets** purchases are funded by issuing **bonds (financial liabilities)**. Bean finds that if the issued **bonds** were not re-measured to F.V through **P/L** an **accounting mismatch** would arise. Therefore Bean initially designates the **bonds** issued to be measured at F.V through **P/L**. Assume the **F.V** of the **bonds payable** fell by \$8,000 during the reporting period of which \$3,000 related to decreased credit worthiness.

Required: How should the **bonds** accounted for?

Answer: When **financial liability** is initially designated to be measured at F.V through **P/L** to reduce **accounting mismatch**, the **F.V** movement would not be split into portion related to change in **credit risk** and other changes in **F.V** but rather the total change in **F.V** is recognised in **P/L**.

Dr: Financial liability \$8,000

Cr: Gain on financial liability \$8,000 → **P/L**

Note: An **accounting mismatch** is a measurement or recognition inconsistency arising from measuring **assets/ liabilities** or recognising **G/L** on them on different bases.

Case three: Derivatives are always measured at F.V through **P/L** for example change in **F.V** of an **obligation** that arises when an entity sells a security that it has borrowed and does not own (short sale) is immediately recognised in **P/L**.

Ex: Diamond Co. Borrowed 40,000 shares of Banana Co. **ordinary shares** from a broker to be **redeemed** after two months and paid \$3,000 fees. Diamond sold the 40,000 shares immediately at its **F.V** of \$18 each. At the end of the first month the **F.V** of Banana's **ordinary share** was \$20 or \$15.

Required: How the previous short sale event is **accounted for** in Diamond's records?

Answer:

When fees are paid to the broker:

Dr: Expenses \$3,000 → **P/L**

Cr: Cash \$3,000

At the end of the first month:

When shares are sold

Dr: Cash $(40,000 \times \$18) = \$720,000$

Cr: **Liability** on short sale \$720,000

At the end of the first month:

F.V of Banana's ordinary share	
\$20	\$15
Dr: Loss $[40,000 \text{ shares} \times (\$20 - \$18)] = \$80,000 \rightarrow \text{P/L}$	Dr: Liability on short sale → current liability (C.L)
Cr: Liability on short sale \$80,000 → current liability (C.L)	Cr: Gain $[40,000 \text{ shares} \times (\$18 - \$15)] = \$120,000 \rightarrow \text{P/L}$

3/1. Financial assets

A. Initial recognition and measurement of financial assets

Initial recognition

A financial asset is **initially recognised** when the entity becomes party to the contractual provisions of the financial instrument.

Remember: All financial derivatives are recognised on the commitment date, not on the date when the item under the derivative contract is transferred from seller to buyer.

Initial measurement

1. Financial assets are initially measured at the transaction price (F.V of the consideration given).

2. If the transaction price is not equal to F.V then, the financial asset is measured at F.V.

Illustrative example (1): On 1, Jan, 2019 Omega purchased a one year call option at \$1,000 to purchase 500 shares in Utopia Co. at \$40 per share. Utopia F.V of share at that date was traded at \$35. On 31, Dec, 2019, the last day of the call option Utopia share was quoted at \$60. Omega exercised the call option on that date.

Required: What is the appropriate accounting treatment of that event on Omega F/S?

Answer:

1, Jan, 2019:

Dr: Financial asset-(call option-derivative) \$1,000

Cr: Cash \$1,000

31, Dec, 2019:

Dr: Financial asset (500 shares × \$60 F.V) = \$30,000 → F.V

Cr: Cash (500 × \$40 strike price) = \$20,000 → (total exercise price)

Cr: Financial asset-(call option-derivative) \$1,000

Cr: Gain on exercising call option \$9,000 → P/L

Illustrative example (2): Regina granted \$5m **interest free loan** to its supplier on 1, Jan, 2018. The **loan** will be paid back on 31, Dec, 2019 as a **single payment**. The market interest rate is 8% per annum. Regina wishes to hold the **loans** at **amortised cost** under IFRS **Accounting Standard # 9 'Financial instruments'**.

Required: How the **loan** is **accounted for**?

Answer: The **loan receivable** is a **financial asset**. Usually **F.V** of the consideration given represents **initial measurement** of the **financial asset**. *However* this is not the case with an **interest-free loan**. An **interest free loan** has a cost to Regina *and* the face value (\$5m) may not be the same as the **F.V**.

F.V of the **loan** is determined by the **P.V** of lump sum (because the **loan** principal will be **redeemed** as a single payment) discounted at market interest rate.

$$\text{P.V} = \frac{\$5,000,000}{(1 + 0.08)^2} = \$4,286,694.$$

1, Jan, 2018:

Dr: **Loan receivable-financial asset** \$4,286,694

Dr: Deferred finance cost \$713,306 → treated as **prepaid expense** allocated to **P/L** using effective interest rate.

Cr: Cash \$5,000,000

Description	31, Dec, 2018	31, Dec, 2019
Dr: Loan receivable	$\$4,286,694 \times 8\% = \$342,936$	$4,629,630 \times 8\% = \$370,370$
Cr: Finance income	\$342,936	\$370,370
Loan receivable balance	$4,286,694 + 342,936 = \$4,629,630$	$4,629,630 + \$370,370 = \5m
Dr: Finance cost	\$342,936	\$370,370
Cr: Deferred finance cost	\$342,936	\$370,370
Dr: Cash		\$5m
Cr: Loan receivable		\$5m

Note: If the **interest free loan** was paid to employees; the difference between the face value of the **loan** *and* the **P.V** \$713,306 will be treated as **deferred employee compensation** that is **recognised** in **P/L** over the **loan** term using effective interest rate.

3. If the **financial asset** is **classified and measured** at **amortised cost** *or* at **F.V** thorough **OCI**; **transaction costs** are **added** to the amount of the **financial asset**. *But if* the **financial asset** is to be measured at **F.V** through **P/L**; **transaction costs** are **expensed**.

B. Subsequent measurement of financial assets

First

Accounting for investments in debt instruments

A financial asset in **debt** instrument can be subsequently classified *and* measured at *either*:

1. Amortised cost; *or*
2. F.V through OCI; *or*
3. F.V through P/L.

Note: Investments in **debt** instruments that can't be reliably measured at F.V should be measured at **amortised cost**.

1. Amortised cost

Per IFRS Accounting Standard # 9; an investment in a **debt** security can be measured at **amortised cost** *if* two criteria are met;

1. Business model test → (Investor)

The entity's business model is to collect the financial asset's contractual cash flows *and* it does not plan on selling the financial asset in **debt** security prior to its maturity to realise its F.V changes *but rather* the entity intends to hold it *until* maturity.

Note:

The accidental sale of investment in **debt** security before maturity **does not** disqualify the use of the 'held-to-maturity' classification *if*:

- A. Sales are attributable to an isolated event that is **beyond** the entity's **control**; *and*
- B. The non-recurring sale could **not** have been reasonably anticipated by the investor (e.g., a significant deterioration in the issuer's creditworthiness)

Thus; for financial asset in **debt** security to be measured at **amortised cost**, the investor should have a positive intent *and* ability to hold it to maturity.

2. Cash flow characteristics test → (**debt security's cash flows**)

The contractual terms of the financial asset in **debt** security give rise on specified dates to cash flows that are solely payments of principal *and* interest on the principal outstanding **with no other features**.

Thus: for financial asset in **debt** security to be measured at **amortised cost**, it should have fixed or determinable cash flow payments *and* fixed maturity dates *and* amounts.

Notes:

1) It is **not** possible to compute **amortised cost** for a **financial instrument** that does not have **fixed or determinable** cash flows *such as equity instruments*.

2) For a **debt security** to be **measured at amortised cost**; its cash flows must have **any** of the following characteristics:

A. Contractual interest to be received is **fixed or zero (zero coupon bond)**; *or*

B. Contractual interest to be received is **floating** *but* linked to a benchmark *such as* LIBOR; *or*

C. Contractual interest to be received is **combination of fixed and floating** *such as* LIBOR plus a fixed spread.

Illustrative example (1): Would an investment in a **convertible bond** qualify to be **measured at amortised cost** under IFRS **Accounting Standard** # 9?

Answer: **No** because the **debt security** includes a **conversion option** which is **not** deemed to represent payments of principal *and* interest. *Thus; if* the contractual cash flows are **not solely** payments of principal *and* interest on the principal; the investment in **debt security** can't be **measured at amortised cost**.

Illustrative example (2): Paloma purchased a **bond** on 31, Dec, 2019. The **bond** will mature in three years. Paloma buys **debt investments** with the **intention of holding them to maturity** *although* has 'on occasion' sold some investments *if* cash flow deteriorated beyond acceptable levels. The **bond** pays a market rate of interest. The Finance Director is unsure *as to whether* this **financial asset** can be **measured at amortised cost**.

Required: Advise the finance director on how the **bond** will be **measured**.

Answer: A **debt instrument** can be held at **amortised cost** *if*:

A. The investor intends to hold the **financial asset** to collect contractual cash flows *rather than* selling it to realise **F.V** changes.

B. The contractual cash flows of the asset are **solely** payments of principal *and* interest on the principal amount outstanding.

Paloma's objective is to hold the **financial assets** *and* collect the contractual cash flows. Making some sales *when* cash flow deteriorates does **not** contradict that objective. The **bond** pays a market level of interest *and therefore* the interest payments received provide adequate compensation for the time value of money *or* the **credit risk** associated with the principal amount outstanding. *This means that* the **financial asset** can be **measured at amortised cost**.

Measurement

1. The **debt security** is **initially recognised** at **F.V** of the consideration given **plus** transaction costs.

2. Interest income is calculated using the **effective interest rate** *and* **recognised in P/L**. No option to use straight line amortisation method.

Illustrative example: *If* the **amortised cost** of an investment in a **zero coupon bond** at the beginning of 2019 is \$100,000 *and* the effective interest rate is 12%.

Required: What is the carrying amount (**amortised cost**) at the end of 2019?

Answer: The **amortised cost** at the end of 2019 = $\$100,000 \times 112\% = \$112,000$

Dr: Investment in **zero coupon bond** \$12,000

Cr: Finance income \$12,000 → **P/L**

3. Changes in F.V at year-end are ignored *unless* permanent decline in F.V.

Illustrative example (1): Tokyo bought a \$100,000 (5% annual interest) **bond** for \$95,000 on 1, Jan, 2018 *and* incurred **transaction costs** of \$2,000. The **bond** will be **redeemed** at a **premium** of \$5,960 on 31, Dec, 2020. The effective interest rate is 8%.

The F.V of the **bond** was as follows:

31/12/2018; \$110,000

31/12/2019; \$104,000

Required: Explain with calculations how the **bond** will be **accounted for** over all relevant years *if* Tokyo's business model is to hold it *until redemption date*.

Answer: *When* the business model is to hold the **bond until redemption**, it will be measured at **amortised cost**.

-The financial asset is **initially recognised** at its F.V of consideration offered \$95,000 *plus* transaction costs \$2,000.

- Finance income will be recognised in **P/L** using effective interest rate.

1, Jan, 2018:

Dr: Investment in **bonds** \$97,000

Cr: Cash \$97,000

Entries	Year-end				Total
	Investment date	2018	2019	2020	
Dr: Cash		\$5,000	\$5,000	\$5,000	\$15,000
Dr: Investment in bonds (SFP)		\$2,760	\$2,981	\$3,219	8,960
Cr: Finance income		\$7,760*	\$7,981**	\$8,219	23,960
Investment balance	\$97,000	99,760	102,741	105,960	
The effective interest rate achieves constant rate in each period over the financial asset life → 8%					

* $\$97,000 \times 8\% = \$7,760$.

** $99,760 \times 8\% = \$7,981$.

31, Dec, 2020:

Dr: Cash \$105,960

Note: F.V is irrelevant in this case.

Illustrative example (2): PQR has an investment in **debentures** (unsecured **bonds**) of STU with nominal value \$40,000 and 4% coupon rate that was purchased on 1, Jan, 2019 at a discount of \$6,000. PQR plans to hold these debentures until **redemption** on 31, Dec, 2022. The internal rate of return of the debentures is 8.60%.

Required: Advise PQR with appropriate calculation (as information permits) about the **accounting** for these debentures stating the effect on PQR gearing for the year-ended 31, Dec, 2019.

Answer: Because these debentures are planned to be held until **redemption**; under IFRS Accounting Standard # 9 'Financial instruments' it would be measured at **amortised cost** assuming that:

A. The objective of the **business model** is to hold these debenture in order to collect contractual cash flows; and

B. The contractual terms of the **financial asset** give rise on specified dates to cash flows that are solely payments of principal and interest.

This means that debentures are initially measured at cost (including transaction costs) and their value increased over time to the **redemption** value by applying **constant** effective interest rate which takes into account not only the annual income due from the coupon but also amortisation of the **redemption premium** (from \$34,000 to \$40,000). Their value is reduced by interest received. Consequently the **amortised cost** of these debentures at 31, Dec, 2019 would be:

Description	Amount	Comments
Acquisition cost (\$40,000 - \$6,000)	\$34,000	
Add: Effective interest at 8.60%	2,924	Cr: Finance income (P/L)
Less: Coupon received (4% × 40,000)	(1,600)	Dr: Cash
Balance at 31, Dec, 2019	35,324	Non-current in the SFP

Note: because debentures are acquired at discount, its carrying amount increases over time from \$34,000 at the inception to \$40,000 at maturity date and finance income will increase over the four periods.

The increase in debentures asset over time and in net income will marginally reduces gearing (**debt ratio**)

Illustrative example (3): On 1, April, 2019 Epsilon loaned \$30m to another entity. Interest of \$1.50m is payable annually in arrears. An additional final payment of \$35.30m is due on 31, March, 2022. Epsilon incurred direct costs of \$250,000 in arranging this loan. The annual rate of interest implicit in this arrangement is approximately 10%. Epsilon has no intention of assigning this loan to a third party at any time.

Required: Explain and show how the previous event should be reported in the F/S of Epsilon for the year-ended 31, March, 2020

Answer: Since the **business model** is to collect the contractual cash flows and the cash flows consist solely of the repayment of principal and interest. This **financial asset** is measured at **amortised cost** where the initial carrying amount of the loan receivable will be \$30.25m (\$30m F.V + \$0.25m transaction costs). The finance income recorded in the statement of P/L for the year-ended 31, March, 2020 will be \$3.025m (\$30.25m × 10%).

The carrying amount of the **financial asset** in the SFP at 31, March, 2020 will be \$31.775m (\$30.25m + \$3.025m - \$1.50m).

Illustrative example (4): Aron granted **interest free loans** to its employees on 1, June, 2018 of \$10m. The **loans** will be paid back on 31, May, 2020 as a **single payment**. The market interest rate is 6% per annum. Aron is unsure how to account for that **loan** but wishes to hold the **loans** at **amortised cost** under IFRS **Accounting Standard # 9 'Financial instruments'**.

The following discount *and* annuity factors may be of use.

Year	Discount factors-lump sum			Annuity factors		
	6%	9%	9.38%	6%	9%	9.38%
One year	0.9434	0.9174	0.9142	0.9434	0.9174	0.9174
Two years	0.8900	0.8417	0.8358	1.8334	1.7591	1.7500
Three years	0.8396	0.7722	0.7642	2.6730	2.5313	2.5142

Required: Discuss with relevant computations how the above **financial asset** should be **accounted for** in F/S^s for the year-ended 31, May, 2019.

Answer: IFRS **Accounting Standard # 9 'Financial instruments'** requires **financial assets** to be measured initially at **F.V plus transaction costs**. Usually **F.V** of the consideration given represents **initial measurement** of the **financial asset**. However this is **not** the case with an **interest-free loan**. An **interest free loan** is **not** costless to the employer *and* the **face value** may **not** be the same as the **F.V**.

To arrive at **F.V** of the **loan**, Aaron needs to consider market interest rate for that two year **loan** on issuance date 1, June, 2018. This rate should be used in **measuring** the instrument. The **F.V** can be **measured** as the **P.V** of future receipts using the **market interest rate** of 6%. There will be a difference between the face value *and* the **F.V** of the **loan** calculated as follows:

Description	Amount
Face value of loan at 1, June, 2018	\$10m
F.V of loan at 1, June, 2018 (\$10m × 0.89)	(8.90m)
Difference	1.10m

This **difference** of \$1.10m is an extra cost to Aron of not charging market interest rate. It will be treated as **employee compensation** charged over the two years to **P/L** under IAS # 19 'Employee benefits'.

Regarding **subsequent measurement**; Aron wishes to hold the **loan** at **amortised cost**.

This requires satisfaction of two criteria under IFRS **Accounting Standard # 9**;

A. Business model test: the **objective** of the entity's **business model** is to hold the **financial asset** to collect the contractual cash flows *rather than* to sell the **instrument** prior to its contractual maturity to realise its **F.V** changes.

B. Cash flow characteristics test: the contractual terms of the **financial asset** give rise on specified dates to cash flows that are **solely** payments of principal *and* interest.

These criteria are met. Accordingly the **loan** can be **measured** at 31, May, 2019 at **amortised cost** using constant effective interest rate of 6%. So the year-end carrying value of the **loan receivable** in the SFP would be \$9.434m (\$8.90m × 1.06). The **loan receivable** is **presented** as current asset. Finance income of \$534,000 will be credited to **P/L** for the year.

Date	Entry	Dr	Cr
1, June, 2018	Dr: Loan receivable Dr: Deferred employee compensation Cr: Cash	\$8.90m \$1.10m	\$10m
31, May, 2019	Dr: Loan receivable (\$8.90m × 6%) Cr: Finance income → P/L	\$534,000	\$534,000
31, May, 2019	Dr: Employee compensation → P/L Cr: Deferred employee compensation	\$534,000	\$534,000
31, May, 2020	Dr: Loan receivable (\$9,434,000 × 6%) Cr: Finance income → P/L	\$566,000	\$566,000
31, May, 2020	Dr: Employee compensation → P/L Cr: Deferred employee compensation	\$566,000	\$566,000
31, May, 2020	Dr: Cash Cr: Loan receivable	\$10m	\$10m

2. F.V through OCI

An investment in **debt** instrument is **measured** at F.V through **OCI** **if** it meets both the following criteria:

1. The entity's **business model** involves both **collecting** contractual cash flows **and** **selling** financial assets.

Note: Sales will be **more frequent** under this classification than for **debt** instruments held at **amortised cost**.

For example: the entity may sell the investments in **debt instrument** **if** the possibility of buying another investment with a higher return arises **or if** the credit worthiness of the debtor is substantially declined.

2. The **financial asset** cash flows characteristics is that; the contractual terms of the **financial asset** give rise to cash flows on **specified** dates that are **solely** payments of interest **and** principal.

Note: An investment in **convertible bond** can't be classified as F.V through **OCI** rather it is classified as F.V through **P/L** because the **bond** includes a **conversion option** which is **not** deemed to represent payments of principal **and** interest. **Thus;** if the contractual cash flows are **not solely** payments of principal **and** interest on the principal; the **investment in debt security** can't be **measured** at either **amortised cost** or F.V through **OCI**.

Illustrative example: Tota expects to incur capital expenditure in a few years' time. Tota invests its excess cash in short and long term **financial assets** in **debt securities** so that it can fund the expenditure when the need arises. Many of the **financial assets** have contractual lives that exceed Tota anticipated investment period. Tota will hold **financial assets** to collect the contractual cash flows and when an opportunity arises, it will sell a **financial asset** to reinvest the cash in another **financial asset** with higher return. The portfolio manager's remuneration is based on the overall return generated by the portfolio.

Required: Determine the classification of this portfolio under IFRS Accounting Standard # 9.

Answer: The objective of the business model is achieved by both collecting contractual cash flows and selling financial assets in debt securities. Tota decides on an ongoing basis whether collecting contractual cash flows or selling financial assets will maximise the return on the portfolio until the need arises for the invested cash. Thus, F.V through OCI may be an appropriate measurement base.

Measurement

A. Investment in debt instrument is initially recorded at F.V plus transaction costs.

B. Finance income is calculated using effective interest rate and recognised in P/L exactly as if the financial asset was held at amortised cost.

C. At each reporting date, the debt instrument is revalued to F.V where the resulting G/L is recognised in OCI. These G/L^s are reclassified to P/L when the financial asset in debt instrument is disposed of or redeemed.

Illustrative example (1): On 1, Jan, 2018 Tokyo bought a \$100,000 (5%) bond for \$95,000 incurring transaction costs of \$2,000. The bond will be redeemed at a premium of \$5,960 on 31, Dec, 2020. The effective interest rate is 8%.

The F.V of the bond was as follows:

31/12/18; \$110,000

31/12/19; \$104,000

Required: Explain with calculations how the bond will be accounted for over all relevant years if Tokyo's business model is to hold bonds until redemption but also to sell them if investments with higher returns become available.

Answer: The business model is to hold the debt instrument until redemption. But sales may be made to invest in other financial assets with higher returns. Therefore the debt instrument will be measured at F.V through OCI as follows:

1. The bond is initially recognised at its F.V plus transaction costs.

Dr: Investment in bonds \$97,000

Cr: Cash \$97,000

2. Finance income is measured at effective interest rate and recognised in P/L similar to financial asset held at amortised cost.

Entries	31, Dec				Total
	Investment date	2018	2019	2020	
Dr: Cash-5% on face		\$5,000	\$5,000	\$5,000	\$15,000
Dr: Investment in bonds		\$2,760	\$2,981	\$3,219	8,960
Cr: Finance income → P/L		\$7,760*	\$7,981**	\$8,219	23,960
Bond balance under amortised cost	\$97,000	\$99,760	\$102,741	\$105,960	
Effective interest rate achieves constant rate in each period over the life of the financial asset → 8%.					

* $\$97,000 \times 8\% = \$7,760$.

** $99,760 \times 8\% = \$7,981$.

3. The **financial asset** is revalued to **F.V** at each year-end. **G/L** will be recorded in **OCI** and will be **reclassified** to **P/L** when the **financial asset** is disposed of or matured.

Description	1, Jan, 2018	31, Dec, 2018	31, Dec, 2019	31, Dec, 2020
Balance based on F.V	\$97,000	\$110,000	\$104,000	\$105,960 (4)
Unadjusted ending balance	\$97,000	\$99,760 (1)	\$112,981 (2)	\$107,219 (3)
Difference (gain or loss)	0	\$10,240 gain	(\$8,981 loss)	(\$1,259 loss)
Dr: Investment in bonds		\$10,240		
Cr: OCI-equity (valuation gain)		\$10,240		
Dr: OCI-equity (valuation loss)			\$8,981	\$1,259
Cr: Investment in bonds			\$8,981	\$1,259

(1) 31, Dec, 2018 balance based on **amortised cost** **\$99,760**.

(2) **F.V** at 31, Dec, 2018 (beginning 2019) $\$110,000 + \$2,981$ discount amortisation for 2019 = **\$112,981**.

(3) **F.V** at 31, Dec, 2019 (beginning 2020) $\$104,000 + \$3,219$ discount amortisation for 2020 = **\$107,219**.

(4) **F.V** at 31, Dec, 2020 is the same as maturity value **\$105,960**.

4. 31, Dec, 2020

Dr: Cash \$105,960

Cr: Investment in bonds \$105,960

Note: the balance of valuation **G/L** under **OCI** on 31, Dec, 2020 is \$nil.

Note: the balance of valuation **G/L** under **OCI** on 31, Dec, 2020 is \$nil.

Illustrative example (2): The controller of Omega received an email from his assistant with the following query regarding F/S^s for the year-ended 31, March, 2020.

I notice that on 1, April, 2019 we lent \$50m to key supplier at an annual rate of interest of 5% **payable** in arrears. The **loan** is repayable on 31, March, 2029 *but* I believe that *if interest rates change we might consider assigning the loan to a third party*. Market interest rates have **fallen** since 1, April, 2019 and the **F.V** of the **loan asset** at 31, March, 2020 was \$52m. I have been told that this **loan asset** should be **measured** at '**F.V** through **OCI**'. Why is this? I thought **loan assets** were **measured** at **amortised cost**. *If the loan asset is measured at F.V through OCI, does the finance income get recorded in OCI rather than P/L?*

Required: Provide answers to the questions raised by the assistant.

Answer: **Measurement basis of financial assets** is set out in IFRS **Accounting Standard** # 9 '**Financial Instruments**'. The **measurement basis** depends on the **business model** for managing the **financial asset** *and* the **contractual cash flow** characteristics of the **financial asset**.

In order for the **financial asset** in **debt instrument** to be **measured** at **amortised cost**; the contractual terms should give rise to cash flows on specified dates which are **solely** payments of principal and interest on the amounts outstanding. This condition is satisfied in the **loan** you are querying. There is *however* another condition to be satisfied. The **financial asset** should be held under a **business model** whose objective is to hold it in order to collect the contractual cash flows. This condition is **not** satisfied given the possibility of assigning the **loan** should market interest rates rise. A **financial asset** is **measured** at **F.V** through **OCI** *where* the 'contractual cash flow test' is passed and the **financial asset** is held under a **business model** whose objective is achieved **both** by collecting contractual cash flows *and* by selling the **financial asset**. This appears to be the case here. So classification as **F.V** through **OCI** seems appropriate. *Where financial asset is measured at F.V through OCI, finance income is included in P/L at the same amount as under amortised cost. Therefore finance income of \$2.50m (\$50m × 5%) will be recorded in P/L. The increase in F.V of \$2m (\$52m - \$50m) will be recorded in OCI.*

3. F.V through P/L (default category)

Cases when the financial asset in debt instrument is measured at F.V through P/L

1. *If the financial asset in debt instrument is not measured at amortised cost or F.V through OCI because the contractual cash flows are not solely payments of principal and interest on the amount outstanding (for example the investment in debt security can be converted to equity security of the issuer at the debt's maturity date). Then it is measured at F.V through P/L (default category).*

2. *If the financial assets in debt instrument is held for trading.*

Note: A **financial asset** is considered to be held for trading *if* the entity acquired it **principally** for the purpose of **selling** it in the **near term** *or* it is part of a portfolio of **financial assets** subject to **trading**. Trading implies **active and frequent** buying *and* selling to **profit** from **short-term** movements in price margin.

3. F.V through **P/L** option to avoid **accounting mismatch** even if a **debt** instrument meets the criteria for measurement at **amortised cost** or F.V through **OCI**; IFRS **Accounting Standard** # 9 allows an entity at initial recognition to **irrevocably** designate that **financial asset** in **debt** instrument as measured at F.V through **P/L** **if** this would eliminate or reduce measurement or recognition inconsistency (**accounting mismatch**).

Measurement

A. The **debt** instrument is initially recognised at F.V. Any transaction costs are **expensed** to **P/L**.

B. At each reporting date the **debt** instrument will be revalued to F.V with **G/L** recognised in **P/L**.

C. Finance income received is **recognised** in **P/L**.

Illustrative example (1): On 1, Jan, 2018 Tokyo bought a \$100,000; 5% **bond** for \$95,000 incurring transaction costs of \$2,000. The **bond** will be **redeemed** at a **premium** of \$5,960 on 31, Dec, 2020. Effective interest rate is 8%.

The F.V of the **bond** was as follows:

31, Dec, 2018; \$110,000

31, Dec, 2019; \$104,000

Required: Explain with calculations how the **bond** will be **accounted for** over all relevant years **if** Tokyo's **business model** is to **trade bonds** in the short-term. Assume that Tokyo sold this **bond** for \$107,000 on 30, June, 2019.

Answer: The **bond** would be **measured** at F.V through **P/L**.

1. The **bond** is initially recognised at its F.V of \$95,000. Transaction cost would be **expensed** to **P/L**.

Dr: Investment in **bonds** \$95,000

Dr: Transaction costs \$2,000 → **P/L**

Cr: Cash \$97,000

2. At 31, Dec, 2018 finance income of \$5,000 ($\$100,000 \times 5\%$) is **recognised** in **P/L**. The **financial asset** would be revalued to \$110,000 with revaluation **gain** of \$15,000 ($\$110,000 - \$95,000$) **recognised** in **P/L**.

Dr: Cash \$5,000

Cr: Finance income \$5,000 → P/L

And

Dr: Investment in **bonds** \$15,000

Cr: Revaluation **gain** of **trading debt securities** \$15,000 → P/L

3. On 30, June, 2019 the **bond** is sold at \$107,000 *thus*: it would be **derecognised**:

Dr: Cash \$107,000

Dr: **Loss** on sale of **debt security** \$3,000 → P/L

Cr: Investment in **bonds** \$110,000

Illustrative example (2): Kappa made three-year **loan** of \$10m to (X) Co. on 1, Oct, 2018. The annual interest rate on the **loan** was 8% **payable** in arrears. On 30, Sep, 2021 Kappa will receive a **fixed** number of shares in (X) Co. as a full settlement of the **loan**. (X) paid the interest due of \$0.80m on 30, Sep, 2019 *and* it has no liquidity problems. The **F.V** of this **loan asset** at 30, Sep, 2019 was estimated to be \$10.50m.

Required: Explain **and** show how the above event would be **reported** in F/S^s for the year-ended 30, Sep, 2019.

Answer: Since the **loan** is at normal commercial rates, it would **initially** be **recognised** at the amount advanced of \$10m. The interest received of \$0.80m would be credited to **P/L** as finance income. *In this case* the **contractual cash flows** **are not** solely payments of principal *and* interest on the principal amount outstanding. *Therefore* the **loan receivable** would be **measured** at **F.V** through **P/L**. **F.V gain** of \$0.50m (\$10.50m - \$10m) is **recognised** in **P/L**. The **loan** would be **presented** as **non-current asset** at \$10.50m.

Summary

Financial assets in **debt** instruments are **measured** under IFRS Accounting Standard # 9 at *either* **amortised cost**, **F.V** *through OCI* *or* **F.V** *through P/L* **based on**:

1. The entity's business model for managing the **financial assets**, *and*
2. The contractual cash flow characteristics of the **financial asset** in **debt security**.

1. Business model test:

Under **business model test**, the investor in **debt instrument** is **required** to assess *whether* its **business objective** for **investment** in **debt instrument** is **solely** to collect the contractual cash flows of the **instrument** **or** to realise its **F.V** changes through sale prior to its maturity.

Notes:

A. The classification of investment in **debt security** based on the **business model** is **not** made at an **individual financial instrument level** *or* at the **entity level** **but** at **portfolio level**. *Thus*, an entity may have **more than one business model** for managing its **financial assets** in **debt securities**.

B. The assessment *and* the classification of a **financial asset** in **debt security** are based on how management **actually manages** the business *rather than* management's **intentions** for specific **debt security**.

C. The objective of an entity's **business model** to hold the **financial asset** in **debt instrument** to collect contractual cash flows **does not contradict with** some **infrequent** sales before maturity could occur.

Illustrative example (1): Jena holds portfolio of **debt investments** in order to **collect their contractual cash flows** (interest *and* principal **redemption**). In some circumstances Jena **might sell an investment** to fund capital expenditure *or* because the credit rating of the issuer falls below an acceptable level.

Required: Determine the classification of this portfolio under IFRS **Accounting Standard # 9**.

Answer: As sales are likely to be **infrequent**, it may still be *considered that* Jena objective is to hold the **debt investments** *and* collect the contractual cash flows. *Thus*, **amortised cost** still an appropriate **measurement bases** in this case.

Illustrative example (2): Rosa **business model** is to purchase portfolios of **financial assets** *such as* **loans**. *Even when* payment on the **loan** is not made on a timely basis, Rosa attempts to collect the contractual cash flows *through* various means of credit control *such as* by contacting the debtor through mail, telephone... In some cases Rosa enters into interest rate **swaps** to change the interest rate on particular **debt security** in the portfolio from a floating interest rate to a fixed interest rate.

Required: Determine the classification of this portfolio under IFRS **Accounting Standard # 9**.

Answer: The objective of Rosa **business model** is to hold the **financial assets** in **debt instruments** *and* collect the contractual cash flows. Rosa does not purchase the portfolio to make profit by selling them. *The fact that* Rosa has entered into an interest rate **swap** which will modify the cash flows of the portfolio **does not change** Rosa's **business model**. *Thus*, **amortised cost** is an appropriate **measurement base**.

Illustrative example (3): Rita expects to **pay cash outflow** in ten years to fund capital expenditure. It invests excess cash in **short term financial assets**. *When* the investments mature, Rita reinvests the released cash in **new short-term financial assets**. Rita **maintains this strategy** *until* the funds are needed *then* it uses the proceeds from **matured financial assets** to fund the capital expenditure. Only sales that are **insignificant** in value occur before maturity (*unless* there is an increase in **credit risk**).

Required: What is the objective of Rita's **business model** under IFRS **Accounting Standard # 9**?

Answer: The objective of Rita's **business model** is to **hold the financial assets** to collect contractual cash flows. Selling **financial assets** is only **incidental**. *Thus*, **amortised cost** is an appropriate **measurement base**.

2. Contractual cash flow test:

Measurement at **amortised cost** or **F.V** through **OCI** are ok *if* the investment in **debt** instrument has only contractual cash flows of principal *and* interest on principal **and** contains no other features *such as* **convertibility option**. *If* it has other features; it would be measured as **F.V** through **P/L**.

Re-classification of financial assets in debt instruments

1. Reclassification rules are **only** applicable to investments in **debt** instruments. *Thus*; **equity** instruments that the entity initially made an **irrevocable** election to be measured at **F.V** through **OCI** can't be subsequently reclassified.

2. According to IFRS **Accounting Standard** # 9 *subsequent to* initial classification, the investor in **debt** instrument is required to **reclassify** the **financial asset** in **debt** instrument *if* the **business model** within which it holds that **financial asset** **changes**.

Illustrative example (1): Romeo has portfolio of commercial **loans** that it holds to sell in the short term (trading). Romeo acquired Joliet that **manages** commercial **loans**. Joliet **business model** is to hold the **loans** in order to collect the contractual cash flows. The portfolio of commercial **loans** is **no longer for sale** *and* it is now held to **collect the contractual cash flows**.

Required: Does this event necessitate a reclassification?

Answer: Yes by acquiring Joliet which in a **business of managing** commercial **loans** i.e. Joliet's **business model** is to hold the **loans** in order to collect the contractual cash flows. It is evident that Romeo is **required** to reclassify the **financial asset** in **debt** instrument from **F.V** through **P/L** to **amortised cost** because the **business model** within which it holds that **financial asset** changes.

Illustrative example (2): A financial services firm decided to shut down its retail mortgage business (**amortised cost**). The firm ceased to give new **mortgage loans** *and* is **actively marketing** its **mortgage loan** portfolio **for sale** (trading).

Required: Does this event necessitate a reclassification?

Answer: The remaining **mortgage loans** will be reclassified from **amortised cost measurement** to **F.V** through **P/L** *until* the remaining portfolio is liquidated because the entity's decision to shut down its retail mortgage business *and* ceasing to give new **mortgage loans** is a clear evidence of change in **business model**.

3. Reclassification is **not** permitted *if* **no change** in the **business model**. For example a change in management intention regarding a **particular financial asset** *or* a temporary disappearance of a particular market for **financial assets** does **not** in itself warrant reclassification.

4. Any reclassification shall be applied **prospectively** from the date of reclassification.

5. *If* a **financial asset** in **debt** instrument is reclassified from **amortised cost** to **F.V** through **P/L**; any **G/L** arising from the difference between the carrying amount *and* **F.V** is **recognised immediately** in **P/L**.

6. *If* a **financial asset** is reclassified from **F.V** to **amortised cost**; **F.V** at the date of reclassification becomes the new carrying amount. No **G/L** arises.

Second

Accounting for investments in equity instruments

General

1. Investments in **equity instruments** *other than* those **accounted for** under equity method are **always measured** at **F.V** because contractual cash flows on specified dates are **not** a characteristic of **equity instruments**, hence **amortised cost** is never used to measure investment in **equity instruments**.
2. Investment in **equity instruments** are **measured** at *either*:
 - A. **F.V** through **P/L** → (normal case) *or*
 - B. **F.V** through **OCI** → (**exception**)
3. Year-end **F.V** is based on **bid price** (the price the broker will pay to buy a share) *rather than* ask price.
4. Transaction cost to **sell such as** brokerage fees that would be incurred *if* the shares were to be sold are **not** a component of **F.V measurement**, so it is **not** deducted from year-end **F.V**.
5. Dividend income is **recognised** in **P/L** for **all equity instruments** *regardless* of how it **measured**.

1. F.V through P/L

1. Investment in **equity instrument** is **measured** at **F.V** through **P/L** *if* it is acquired for **trading** (normally).
2. Investment in **equity instrument** that is classified as **F.V** through **P/L** is **initially recognised** at **F.V**. Transaction costs are **expensed** to **P/L**.
3. At each reporting date, the **equity instrument** is revalued to **F.V**. **G/L** is **recognised** in **P/L**.
4. **Derivative financial assets** are **initially recognised** at **F.V** and are re-measured to **F.V** at each reporting date. **G/L** on **F.V measurement** is **recognised** in **P/L** (*unless* the **derivative** is designated as a **hedging instrument**-see later).

Illustrative example (1): On 1, Jan, 2019 Epsilon purchased 100,000 **call options** (right to buy) to purchase 100,000 shares in **unrelated** entity on 31, Dec, 2019 for \$6 per share for **speculation** purposes. Epsilon paid \$1.25 per **option** on 1, Jan, 2019.

On 31, March, 2019 the **F.V** of a share was \$8 and the **F.V** of each **share option** was \$1.60.

Required: Explain how this event is **reported** in Epsilon F/S^s for the year-ended 31, March, 31, 2019

Answer: The **call option** can't be **measured** at **amortised cost** *or* **F.V** through **OCI**; it must be **measured** at **F.V** through **P/L**. The initial value of the **call option** is \$125,000 (100,000 **options** × \$1.25). At year-end the **call option** will be re-measured to its **F.V** of \$160,000 (100,000 × \$1.60). **F.V gain** of \$35,000 (\$160,000 - \$125,000) is **recognised** in **P/L**.

At acquisition date:

Dr: Investment in financial asset-(derivative-call option) \$125,000

Cr: Cash \$125,000

31, March, 2019:

Dr: Investment in financial asset-(derivative-call option) [100,000 options × (\$1.60 - \$1.25)] = \$35,000.

Cr: Valuation gain on call option \$35,000 → P/L

Illustrative example (2): Assume Thomson Co. **purchased** for \$3 each 1,000 **call option** on 15, Dec, 2019 *and* paid \$500 commissions. The **call option** gives it a **right** (*but not an obligation*) to purchase 1,000 **shares** issued by entity (B) on 15, April, 2020 at an exercise price (i.e., strike price) of \$100 per share.

On 31, Dec, 2019 the **F.V** of each **call option** is \$4.

On 15, April, 2020 the **F.V** of each **option** is \$10 because the **share** price on this date is \$110.

Required: Prepare the appropriate journal entries.

Answer: Under IFRS **Accounting Standard** # 9, **financial assets** are initially **recognised** at **F.V**.

15, Dec, 2019:

Dr: Call option-financial asset \$3,000 → SFP → F.V

Dr: Expenses \$500 → P/L

Cr: Cash \$3,500

31, Dec, 2019:

Dr: Call option-financial asset \$1,000 → SFP → F.V

Cr: Derivative gain \$1,000 → P/L

15, April, 2020:

Dr: Call option-financial asset \$6,000 → SFP → F.V

Cr: Derivative gain \$6,000 → P/L

Exercising the option by derecognition of call options and receipt of shares:

Since the share price is higher than the exercise price, Thomson decided to exercise the **option** by buying 1,000 **shares** for \$100 per share.

\$100 per share.

Dr: Investment in equity security-financial asset \$110,000 → F.V → SFP

Cr: Cash \$100,000

Cr: Call option-financial asset \$10,000

2. F.V through OCI

1. F.V through OCI is an exception for measuring investment in equity securities. It will be used **if** the following conditions are met:

A. The equity instrument must not be held for trading but rather the entity intends to hold it indefinitely (as a strategic investment for long term), and

B. The entity made an **irrevocable election** upon initial recognition that the financial asset in equity instrument will be measured at F.V through OCI. If no such election is made on purchase then; it must be accounted for as F.V through P/L.

2. Equity instruments that the entity initially made an **irrevocable election** to be measured at F.V through OCI can't be subsequently reclassified.

3. Investments in equity instruments that are classified as F.V through OCI are initially recognised at F.V plus transaction costs.

4. At each reporting date the equity instrument is revalued to F.V; G/L is recorded in OCI and will not be reclassified to P/L. The balance of AOCI may eventually be transferred to R.E^s as a reserves movement.

5. Although the Conceptual Framework makes no clear conceptual distinction regarding G/L reported in P/L and G/L reported in OCI; the distinction between them does have practical relevance especially for listed entities. Such entities are required to report their EPS under IAS # 33 'EPS'. G/L reported in P/L affect EPS whereas G/L reported in OCI does not.

Thus; the key difference between reporting changes in F.V of equity instrument as part of P/L or as part of OCI is that; G/L reported in P/L affects EPS which is a key performance measure for listed entities

Illustrative example (1): In 15, Jan, 2019 Wolf Co. purchased 10m \$1 par listed equity shares in Hall Co. at a price of \$5 per share. Transaction costs were \$3m. At the year-end 30, Nov, 2019 the shares were trading at \$6.50.

On 31, Oct, 2019 Wolf received dividend of 20c per share.

Required: Show the F/S^s extracts at 30, Nov, 2019 relating to the investment in Hall on the basis that:

1. The shares were bought for trading;

2. The shares were bought as a source of dividend income and Wolf irrevocably elected at initial recognition to recognise them at F.V through OCI.

Answer:

Date	If shares were bought for trading F.V through P/L	If the shares were bought as a source of dividend income and there is an irrevocable election at initial recognition to measure them at F.V through OCI
Shares acquisition 15, Jan, 2019	Dr: Investment in shares $(10m \times \$5) = \$50m$ Dr: Transaction cost \$3m → P/L Cr: Cash \$53m	Dr: Investment in shares $[(10m \times \$5) + \$3m] = \$53m$ Cr: Cash \$53m
Dividend 31, Oct, 2019	Dr: Cash \$2m Cr: Dividend income \$2m → P/L	Dr: Cash \$2m Cr: Dividend income \$2m → P/L
F.V \$6.50 per share 30, Nov, 2019	Dr: Investment in shares $(10m \times \$1.50) = \$15m$ Cr: Re-measurement gain \$15m → P/L	Dr: Investment in shares $(\$65m - \$53m) = \$12m$ Cr: Re-measurement gain-OCI \$12m → not reclassified to P/L

F.V through P/L		F.V through OCI	
P/L		P/L	
Dividend income	\$2m	Dividend income	\$2m
Transaction cost	(3m)		
Re-measurement gain	\$15m		
Net profit or loss for the year	XXXX	Net profit or loss for the year	XXXX
OCI		OCI	
		Re-measurement gain on shares	12m
CI	XXXX	CI	XXXX
SFP		SFP	
Non-current assets		Non-current assets	
		Investment in shares	\$65m
Current assets		Current assets	
Investment in shares	\$65m		
Equity		Equity	
		Re-measurement gain	\$12m

Illustrative example (2): Your assistant sent you the following memo; I've been analysing Epsilon's **equity investments** and they appear to be being treated inconsistently in the F/S^s. I have noted the following:

- We have a portfolio of **equity investments** which we use for the **short-term investment of surplus cash**. *When* we need cash for business purposes we **sell** some investments from this portfolio. The portfolio is **measured** at its **F.V** each year-end. Any surpluses or deficits on **re-measurement to F.V** are **recognised in investment income** as part of the **P/L** for the period.
- We have two **long-term equity investments** in key suppliers which we have held for some time *and have no intention of* selling them. These investments are **measured at F.V** through **OCI**.

How can it be consistent to report changes in the **F.V**'s of our **equity investments** as different line items in the same F/S^s? Please explain the **measurement** requirements of the relevant IFRS **Accounting Standards**. Additionally what difference does it make to Epsilon *whether G/L*'s are **reported in OCI** *rather than* as part of the **P/L** for the period?

Required: Provide answers to the questions raised by your assistant assuming that Epsilon is a listed entity.

Answer: **Equity investments** are **financial assets** and are subject to the **recognition and measurement** requirements of IFRS **Accounting Standard** # 9 'Financial Instruments'. IFRS **Accounting Standard** # 9 identifies **three classes** for **financial assets**. **Amortised cost**, **F.V** through **OCI** or **F.V** through **P/L**. IFRS **Accounting Standard** # 9 states that the class into which a particular **financial asset** is allocated depends on the **business model** for managing the **financial assets** and the **contractual cash flows** associated with those assets.

Amortised cost can only be used *where* the contractual cash flows consist **solely** of the receipt of interest *and* repayment of the principal sums outstanding. This **does not apply to equity shares** so the **amortised cost** method can't be used. The **default category** for **measuring equity investments** is at **F.V** through **P/L**. This is the method which has been used for the portfolio which has been held for the **short-term investment** of surplus cash. *However if an equity investments is not held for trading it is possible to make an irrevocable election on initial recognition* to measure the **investment** at **F.V** through **OCI**. This election has been made in respect of the **equity investments** in two key suppliers which we have held for the long term *and have no intention of selling*. The key difference *regarding reporting G/L* as part of **P/L** or as part of **OCI** is that; in the former case the **G/L** affects EPS which is an important performance measure for listed entities like Epsilon.

Illustrative example (3): Gamma prepares its F/S^s to 30, Sep each year. The following event is relevant to Gamma's F/S^s. Gamma **purchased** 200,000 **equity shares** in entity (A) (key supplier) on 1, Oct, 2018. Entity (A)'s shares are **listed** on the local stock exchange. This share purchase did not give Gamma control or significant influence over entity (A) *but* Gamma **intends to retain** the shares in entity (A) as a **long-term strategic investment**. Gamma paid \$2.40 per share. This amount represents their **F.V** at the date of purchase. *Additionally* brokers charge a fee of 2% of the amounts paid to **buy or sell** a share on the stock exchange on which entity (A)'s shares are quoted. On 31, March, 2019 entity (A) paid a dividend of 25 cents per share. For the last few years entity (A) has made just one dividend payment each year in the month of March. On 30, Sep, 2019 information received from the local stock exchange *regarding* entity (A)'s share price was:

- Broker's **bid price** (the price the broker will pay to **buy** a share) is \$2.70 per share.
- Broker's **ask price** (the price which the broker requires *when selling* a share) is \$2.90 per share.

Required: Explain *and* show how this event would be **reported** in Gamma F/S^s for the year-ended 30, Sep, 2019. **Note:** *Where alternative reporting treatments are permitted you should explain and show both alternatives.*

Answer: Under the principles of IFRS Accounting Standard # 9 'Financial Instruments' equity investments must be measured at F.V because the contractual terms associated with the investment do not entitle the holder to specific payment of interest and principal. The F.V of the investment in entity (A) at the date of purchase is \$480,000 (200,000 shares × \$2.40). The amount actually paid for the shares incorporating broker's fee on 1, Oct, 2018 was \$489,600 (480,000 × \$1.02). The difference between the price paid for the shares and their F.V is \$9,600 (\$489,600 - \$480,000). This difference is regarded as a transaction cost by IFRS Accounting Standard # 13 'Fair Value Measurement'. IFRS Accounting Standard #9 would normally require equity investments to be measured at F.V through P/L. Where financial assets are measured at F.V through P/L, transaction costs are recognised in P/L as incurred. Therefore in this case \$9,600 would be taken to P/L on 1, Oct, 2018. Under the principles of IFRS Accounting Standard # 13; the F.V of an asset is the amount which could be received to sell the asset in an orderly transaction. Where the asset is traded in an active market as is the case for the investment in entity (A) then F.V should be determined with reference to prices quoted in that market. Therefore the F.V of the investment in entity (A) at the year-end is \$540,000 (200,000 × \$2.70). The year-end F.V of \$540,000 is unaffected by the broker's fees which would be incurred if the shares were to be sold, these fees are not a component of F.V measurement. The change in F.V of \$60,000 (\$540,000 - \$480,000) between 1, Oct, 2018 and 30, Sep, 2019 would be taken to P/L at the end of the reporting period. The dividend received of \$50,000 (200,000 × 25 cents) would be recognised as other income in P/L at 31, March, 2019.

Because the shares in entity (A) are not held for trading, Gamma has the option to make an irrevocable election on 1, Oct, 2018 to measure the shares at F.V through OCI. Where this election to be made then; the transaction cost would be included in the initial carrying amount of the financial asset making this \$489,600, the difference between the closing F.V of the investment and its initial carrying amount is \$50,400 (\$540,000 - \$489,600). This is recognised in OCI. The dividend income of \$50,000 is still recognised in P/L regardless of how the financial asset is measured.

3/2. General revision

Example (1): One of the issues covered by IFRS Accounting Standard # 9 'Financial Instruments' is the classification and measurement of financial assets. The three possible measurement bases identified by the standard are:

1. Amortised cost.
2. F.V through OCI.
3. F.V through P/L.

Required: Explain how IFRS Accounting Standard # 9 requires entities to select the appropriate measurement basis for a financial asset. You should include any options available to entities regarding classification.

Answer: Under IFRS Accounting Standard # 9; the basis for classifying and measuring financial assets are (1) the business model for managing the financial asset and (2) the contractual cash flow characteristics of the financial asset. Where the business model for managing the financial asset is to hold the financial asset to collect the contractual cash flows and where the contractual terms of the financial asset give rise on specified dates to cash flows which are solely payments of principal and interest on the amount outstanding then the financial asset is measured at amortised cost.

Where the business model for managing the financial asset is to both hold the financial asset to collect the contractual cash flows and to sell the financial asset and where the contractual terms of the financial asset give rise on specified dates to cash flows which are solely payments of principal and interest on the amount outstanding then the financial asset is measured at F.V through OCI.

If a financial asset is not measured at amortised cost or F.V through OCI then; it is measured at F.V through P/L (the default category).

An entity may at initial recognition irrevocably designate a financial asset in debt instrument as measured at F.V through P/L if this would eliminate or reduce a measurement or recognition inconsistency which would otherwise arise from measuring assets or liabilities or recognising G/L on them on different bases (accounting mismatch).

Also the entity can make an optional irrevocable election on initial recognition that particular investments in equity instruments which would otherwise be measured at F.V through P/L be measured at F.V through OCI. This election is only possible if the equity investment is not 'held for trading'.

Example (2): You are the chief accountant of Epsilon. An executive of Epsilon who is not an accountant but takes keen interest in financial matters has reviewed the most recent F/S^s of the entity and send you the following query:

An accounting policy note states that our investments in equity shares of other entities are measured at their F.V with changes in F.V being taken directly to OCI. Surely unless all value changes are reported in P/L the shareholders will have an incomplete picture of financial performance. In addition investments in redeemable P/S^s of other entities are measured at amortised cost. I don't understand the meaning of 'amortised cost' and would like an explanation please. It seems inconsistent to treat similar investments in different ways. Please explain this too.

An accounting policy note states that our investments in equity shares of other entities are measured at their F.V with changes in F.V being taken directly to OCI. Surely unless all value changes are reported in P/L the shareholders will have an incomplete picture of financial performance. In addition investments in redeemable P/S^s of other entities are measured at amortised cost. I don't understand the meaning of 'amortised cost' and would like an explanation please. It seems inconsistent to treat similar investments in different ways. Please explain this too.

Required: Draft a reply that responds to the query raised by the executive. Where relevant you should refer to appropriate IFRS Accounting Standards.

Answer: Investments in shares of other enterprises are regarded as financial instruments. The recognition and measurement of such instruments is dealt with by IFRS Accounting Standard # 9 'Financial instruments'. IFRS Accounting Standard # 9 states that the measurement basis for financial instruments depends on their initial classification.

Investments in the equity shares of other entities could potentially be classified in one of two ways. One possibility is that investment is classified as F.V through P/L. This classification essentially means that the investment is held for trading. Such investments are measured at their F.V with F.V changes being recognised in P/L. The other possibility is that the equity instrument is measured at F.V through OCI when the equity instrument is not held for trading and the entity made an irrevocable election upon initial recognition that the financial asset in equity instrument will be measured at F.V through OCI. This occurs when the entity intends to hold it indefinitely (for long term appreciation). In this case F.V value changes are taken directly to OCI and not recycled to P/L. The balance of OCI may be eventually transferred to R.E^s as a reserves movement when the investment in equity security is derecognised. This is what appears to be appropriate for our particular ordinary equity investment.

Investment in redeemable P/S^s is viewed as investment in debt security and could in theory be classified as F.V through P/L. If so the accounting treatment would be to recognise changes in F.V in P/L as G/L. The alternative classification is that the investment could be regarded as a held to maturity investment since it has a fixed maturity date (which investments in equity shares do not have). IFRS Accounting Standard # 9 requires that investments classified in this way should be measured at amortised cost. This therefore is the classification used for these particular investments.

The amortised cost of a financial asset is the amount initially invested minus any interim amounts receivable from the investment plus or minus the amortisation of any difference between the initial amount invested and the amount receivable on maturity. Any amortisation is recognised over the term of the investment using the 'effective interest method'. This method applies an effective interest rate to the opening carrying amount of the investment for each period.

The effective interest rate is the discount rate that exactly discounts the expected future cash receipts from the investment over its whole term to the amount initially invested.

4/1. Introduction

1. A **financial asset** in **debt instrument** is considered to be **impaired** when its carrying amount **can't** be reasonably expected to be recovered through *either* future generation of income *or* sale proceeds.
2. A **credit loss** is the difference between the cash flows the creditor/ investor in **debt instrument** is contractually entitled to receive **and** the cash flows which are expected based on current circumstances.
3. **Credit loss** results from **credit risk**.
4. **Credit risk** (**default risk**) is the **risk** that the **debtor** will partially *or* fully fail to pay amounts owed as it become due.

4/2. Incurred loss model V.S Expected loss model

Incurred loss model

Under 'IAS # 39' provisions it was assumed that; financial assets in debt instruments would be repaid *unless* objective evidence to the contrary (i.e. occurrence of an event that triggers **impairment loss** recognition). Accordingly expected loss on debt instruments that could result from future events *no matter how likely* were not recognised.

Disadvantage of incurred loss model

Following the credit crunch resulted from the global financial crisis many banks had not written down financial assets in debt instruments *despite* having little expectation of collection. This resulted in finance income and financial assets in debt instruments being overstated because no early warning system was in place.

Expected loss model

As a response; IFRS Accounting Standard # 9 introduced **forward-looking impairment loss model** 'Expected loss model' for financial assets in debt instruments to help entities to determine and provide for **expected credit loss** *instead of* waiting for an actual debtor's default.

Advantages of expected loss model

A. Financial assets in debt instruments are no longer overstated.

B. The F/S^s are now reflecting the deterioration or improvement in the credit quality of financial instruments.

Accordingly more useful and timely information are now given to F/S^s users as they will be early warned about potential credit loss *resulting from* credit risk.

4/3. Scope of IFRS Accounting Standard # 9 'Expected loss model'

IFRS Accounting Standard # 9 through applying expected loss model; simplified and unified measuring and recognition of loss allowance due from credit risk (default risk) to the following:

1. Financial assets in debt securities measured at amortised cost or F.V through OCI but financial assets in debt securities measured at F.V through P/L are not subject to impairment testing because changes in F.V are automatically recognised in P/L.
2. Loan commitments when there is a present obligation on the entity to extend credit except those measured at F.V through P/L;
3. Financial guarantee contracts to which IFRS Accounting Standard # 9 is applied except those measured at F.V through P/L;
4. Lease receivables (net investment in finance lease) under IFRS Accounting Standard # 16 'Leases'; and
5. Contract assets and trade receivable under IFRS Accounting Standard # 15 'Revenue from contracts with customers'.

4/4. Indicators of credit impairment

Under IFRS Accounting Standard # 9; a financial asset in debt instrument (or group of financial assets in debt instruments) is credit-impaired when one or more of the following events that have a detrimental impact on the estimated future cash flows from that financial asset occurs:

1. Significant financial difficulty of the issuer or the borrower;
2. A breach of contract such as delinquency or default in either the interest or principal payments;
3. The borrower being granted concessions by the lender for economic or legal reasons relating to its financial difficulty;
4. It becoming probable that the debtor will enter bankruptcy or financial reorganisation;
5. The disappearance of an active market for that financial asset on debt instrument because of the issuer's financial difficulties;
6. The purchase or origination of the debt instrument at deep discount that reflects the incurred credit losses.

Note: Several events may combine to cause a financial asset in debt instrument to become credit-impaired.

4/5. The 'Three stage' expected credit loss model

The 'Three stage' expected credit loss model for **measuring** expected credit loss is as follows:

Stage one

When credit quality has not significantly deteriorated

(low credit risk)

1. If the credit risk is low; credit loss allowance would be established or modified based on the next 12-months expected credit loss.

2. Allowance based on 12-months expected loss = Debtor's default Probability in next 12-months × P.V amount of lifetime expected credit loss.

3. Finance income will be calculated on the gross carrying amount of the financial asset.

Case study: Orange advanced a seven-year interest bearing loan of \$2m to Lemon on 1, May, 2016. Annual interest is 9% paid quarterly in arrears. Assume at 30, Sep, 2016 that, estimated default risk in the next 12-months is 2% and estimated default risk over the remaining term of the loan is 5.50%. The P.V of lifetime loss that would result from the default was estimated at \$800,000.

Required: Calculate credit loss allowance that Orange should record on initial recognition of the allowance at year-ended 30, Sep, 2016 based on low credit risk.

Answer: Because the credit risk is low; credit loss allowance would be established based on the next 12-months expected credit loss.

Allowance based on 12-months expected loss = debtor's default probability in next 12-months 2% ×

P.V amount of lifetime expected credit loss \$800,000 = \$16,000.

12-months expected credit loss is a portion of lifetime expected credit loss that result from default events expected within the next 12-months.

Dr: Impairment loss on debt instrument \$16,000 → P/L

Cr: Allowance of credit risk \$16,000 → contra financial asset

The net carrying amount of the financial asset on the SFP at 30, Sep, 2016 = \$2m - \$16,000 = \$1,984,000

Finance income will be calculated on the gross carrying amount of the financial asset.

Thus; accrued interest on 30, Sep, 2016 would be $\$2m \times \frac{9\%}{12 \text{ Months}} \times 2 \text{ months} = \$30,000$.

Dr: Interest receivable \$30,000

Cr: Finance income \$30,000

Stage two

When credit quality has significantly deteriorated

But No objective evidence on impairment

1. If the credit quality of the financial instrument has significantly deteriorated since their initial or subsequent recognition based on rebuttable assumption that; **contractual cash flows are 30 days past due** (overdue) then; **allowance** of the credit risk is re-measured based on **lifetime** expected credit loss (probability and P.V amount)

2. **Allowance based on lifetime expected loss** = Debtor's **lifetime Probability** of default × P.V amount of **lifetime** expected credit loss.

3. Finance income is still calculated based on **gross** carrying amount of the financial asset.

Continued: from the case study above assume that at 30, Sep, 2017 (second year-end): due to non-receiving interest for the quarter-ended 31, July, 2017 management estimated the probability of default in the next 12-months at 1.50% and in the remaining loan term is 4.50%. The P.V of lifetime loss that would result from the default was estimated at \$900,000.

Required: Calculate credit loss allowance that should be included in the SFP at 30, Sep, 2017.

Answer: Since the contractual cash flows related to interest is two months overdue, the credit risk allowance is re-calculated based on lifetime expected credit loss (probability and P.V amount) because a subjective evidence based on rebuttable assumption exists (the contractual cash flow of interest is 30 days overdue).

Allowance based on lifetime expected loss = debtor's **lifetime Probability** of default 6% × P.V amount of **lifetime** expected credit loss \$900,000 = \$54,000.

Notes:

1. **Lifetime expected credit loss** is the expected credit loss that results from all possible default events over the expected remaining life of a financial instrument.

2. **P.V of lifetime expected credit loss** is the expected shortfall in contractual future cash flows discounted at the **original** effective interest rate of the debt instrument. (See later).

Dr: Impairment loss on debt instrument (\$54,000 - \$16,000) = \$38,000 → P/L

Cr: Allowance of credit risk \$38,000 → contra financial asset

The net carrying amount of the financial asset on the SFP at 30, Sep, 2017 = \$2m - \$54,000 = \$1,946,000.

Finance income will continue to be calculated on **gross** carrying amount of the financial asset. Thus; accrued interest on

30, Sep, 2017 would be $\$2m \times \frac{9\%}{12 \text{ Months}} \times (3 \text{ months overdue} + 2 \text{ months}) = \$75,000$.

Dr: Interest receivable \$75,000

Cr: Finance income \$75,000

Continued: from the case study above assume that before 30, Sep, 2017 issuance of the F/S^s the overdue interest was received. Management still estimate the default **risk probability** in the **next 12-months** at 1.50% and in the **remaining loan** term is 4.50%. The **P.V** of **lifetime loss** that would result from the default still estimated at \$900,000.

Required: Calculate **credit loss allowance** that should be included in the SFP at 30, Sep, 2017.

Answer: Since the overdue interest was received before 30, Sep, 2017 issuance of the F/S^s, this event is an **adjusting event** according to IAS # 10 'Events after the reporting period'

Per IFRS **Accounting Standard** # 9; if the credit quality subsequently improved and the **lifetime** expected credit loss criterion is no longer met; the **allowance** would be re-calculated based on **12-month** expected credit loss.

Allowance based on 12-months expected loss = debtor's default **Probability** in next 12-months **1.50%**
× **P.V** amount of **lifetime** expected credit loss **\$900,000** = \$13,500.

Dr: **Allowance** of credit risk \$40,500 → reduction

Cr: **Impairment loss** recovery on debt instrument = (\$54,000 - \$13,500) = \$40,500 → **P/L**

The net carrying amount of the financial asset on the SFP at 30, Sep, 2017 = \$2m - \$13,500 = \$1,986,500.

Note: Future finance income will be calculated on the gross amount of the debt instrument \$2m.

Stage three

When credit quality has significantly deteriorated with objective evidence on impairment

1. If the credit quality of the financial instrument has significantly deteriorated since their initial or subsequent recognition based on **objective evidence** of **impairment** then; credit **risk allowance** is re-calculated based on **lifetime** expected credit loss (probability and **P.V** amount).

2. Allowance based on lifetime expected loss = Debtor's **lifetime Probability** of default × **P.V** amount of **lifetime** expected credit loss.

3. Finance income is calculated based on **net** carrying amount of the financial asset.

Continued: from the case study above assume that: at 30, Sep, 2018 (third year-end) estimated default **risk** in the next 12-months is 3.50% and in the remaining term of the **loan** is 10.50%. The **P.V** of **lifetime** default **loss** estimated at \$750,000.

Required: Calculate **credit loss allowance** that should be included in the SFP at 30, Sep, 2018.

Answer: Since total default **risk** has increased **significantly** from 6% to 14% at the third year-end, the credit **loss allowance** must be based on **lifetime** expected loss (probability and **P.V** amount).

Allowance based on lifetime expected loss = debtor's **lifetime Probability** of default **14%** × **P.V** amount of **lifetime** expected credit losses **\$750,000** = \$105,000.

Dr: **Impairment loss** on debt instrument (\$105,000 - \$13,500) = \$91,500 → **P/L**

Cr: **Allowance** of credit risk \$91,500 → contra financial asset

The net carrying amount of the financial asset on the SFP at 30, Sep, 2018 = \$2m - \$105,000 = \$1,895,000.

Finance income will be calculated on the financial asset's net carrying amount.

Thus, accrued interest on 30, Sep, 2018 would be $\$1,895,000 \times \frac{9\%}{12 \text{ Months}} \times 2 \text{ months} = \$28,425$.

Dr: Interest receivable \$28,425

Cr: Finance income \$28,425

Conclusion: if the credit risk has significantly increased since initial or subsequent recognition then; the allowance will be increased to lifetime expected credit losses (probability and P.V amount).

Continued: from the case study above assume that; at 30, Sep, 2019 F/S¹ (fourth year-end), the estimated default risk in the next 12-months is 1% and in the remaining loan term is 1.50%. The P.V of lifetime default loss was estimated at \$450,000

Required: Calculate the credit loss allowance that should be included in the SFP at 30, Sep, 2019.

Answer: Since the total default risk has significantly decreased from 14% to 2.50%, a significant improvement in credit quality requires 12-months expected credit loss allowance to be reinstated.

Allowance based on 12-months expected loss = debtor's default Probability in next 12 months 1% ×

P.V amount of lifetime expected credit loss \$450,000 = \$4,500.

Dr: Allowance of credit risk \$100,500 → reduction

Cr: Impairment loss recovery on debt instrument = (\$105,000 - \$4,500) = \$100,500 → P/L

The net carrying amount of the financial asset on the SFP at 30, Sep, 2019 = \$2m - \$4,500 = \$1,995,500.

Finance income will be calculated on the gross carrying amount of the financial asset.

Thus, accrued interest on 30, Sep, 2019 would be $\$2m \times \frac{9\%}{12 \text{ Months}} \times 2 \text{ months} = \$30,000$.

Dr: Interest receivable \$30,000

Cr: Finance income \$30,000

Illustrative example: Tahoe acquired bonds that were issued by San Fran; Tahoe intends to hold it until maturity.

Initial assessment of the bond's credit risk was low due to issuer's strong capacity to fulfill its short-term obligations. Later it was perceived that adverse changes in the economic environment could have a detrimental impact on San Fran's liquidity.

At Tahoe's reporting date, the following information about San Fran was available:

1. Sales have declined 15% over the past 6 months;
2. Credit agencies are reviewing its credit rating but no changes have yet been made;
3. Although market bond prices have remained static, San Fran's bond price has fallen dramatically.

Required: Discuss the **accounting treatment** of the **bond** in Tahoe's F/S⁵ at the reporting date.

Answer: Using available information, Tahoe needs to assess *whether* the **bond's credit risk** has increased significantly since inception. It would seem that San Fran's performance has **declined** and this may have an adverse impact on its liquidity. The review of San Fran's credit rating by external agencies is suggestive of wider concerns about its deteriorated performance and financial position. *The fact that market bond prices are static indicates that* the decline in San Fran's **bond** price is **entity-specific**. This is likely to be a response to its **increased credit risk**. Based on the above it would seem that; the **bond's credit risk** is no longer low. *As a result* it can be concluded that **credit risk** has **significantly increased** since inception. Thus; Tahoe must adjust the **initial loss allowance** on the **bond** (if any) to **lifetime** expected credit losses.

Important notes:

1. Estimate of expected **credit loss** should be **unbiased** and calculated based on **expected value approach** (probability-weighted) it should **not** be calculated based on best or worst-case scenario.

True or false; when measuring expected credit losses under IFRS **Accounting Standard # 9 impairment model**; entities should always consider the worst-case scenario.

Answer: False: Probability-weighted outcome is used to reflect the estimated amount of credit loss.

2. Estimate of expected **credit losses** should be based on **time value of money** (discounted based on original effective interest rate).

3. IFRS **Accounting Standard # 9** requires entities (creditors) to reassess **default risk** at each reporting date by considering **past information** **current** economic conditions and reasonable supportable forecasts. Based on this reassessment, the **loss allowance** is recalculated. Thus; an **allowance** that was previously based on **lifetime credit losses** could be recalculated based on **12-months expected credit losses** due to reduction in **credit risk** or vice versa.

Accordingly; expected **credit losses** are updated at each reporting date for new information and changes in expectations even if there has not been a significant increase in **credit risk**. A 'crystal ball' is **not** required (without undue cost or effort).

4. The **allowance** can be presented as a contra **financial asset** on the face of SFP or in notes.

5. '**Investment grade**' financial instruments (AAA to BBB) have low **credit risk**. Thus; it would **not** meet **lifetime** expected credit losses criterion.

6. Expected **credit losses** related to **unrecognised financial assets** such as **loan commitment** or **financial guarantee** contracts are credited to a **provision** rather than **allowance** because **no** recognised financial asset exists to be subtracted from.

7. As a simplifying measure; IFRS **Accounting Standard # 9** allowed **loss allowance** of trade receivables and lease receivables that do not have financing element to always be measured based on **lifetime** expected credit loss. Re-measurement loss or recovery is recognised in **P/L**.

8. Significant concentration of **credit risk** related to **all** financial instruments must be disclosed in notes to F/S⁵.

Concentration of credit risk exists when a number of debtors are engaged in similar activity/industry/sector or have similar economic characteristics such that their ability to meet **obligations** is similarly affected. Ex: giving **loans** to many entities in the same industry sector that its profits significantly **impaired** due to intense foreign competition.

Required: Outline the requirements of IFRS Accounting Standard # 9 as regards the **impairment** of financial assets.

Answer: The **impairment** model in IFRS Accounting Standard # 9 'Financial Instruments' (July 2014) is based on the idea of providing for expected **losses**. The F/S' should reflect the general pattern of deterioration *or* improvement in the credit quality of financial instruments within the scope of IFRS Accounting Standard # 9. This is a **forward-looking impairment** model.

IFRS Accounting Standard # 9 requires entities to base their **measurement** of expected credit **losses** on reasonable *and* supportable information that is available *without* undue cost *or* effort. This will include historical, current **and** forecasted information.

Expected credit **losses** are updated at each reporting date for new information *and* changes in expectations *even if* there has not been a significant increase in credit **risk**.

On initial recognition the entity must create a credit loss allowance/provision equal to 'twelve months' expected credit **losses**. This is calculated by multiplying the probability of a default occurring in the next twelve months by the **total lifetime** expected credit **losses** that would result from that default. (This is not the same as the expected cash **shortfalls** over the next 12-months).

In subsequent years *if* the credit **risk** significantly increased since initial recognition; this amount will be replaced by **lifetime** expected credit **losses**. *If* the credit quality subsequently improves *and* the **lifetime** expected credit **losses** criterion is no longer met; the 12-months expected credit loss basis is reinstated.

The amount of the **impairment** to be recognised on these financial instruments depends on *whether or not* they have significantly deteriorated since their initial recognition.

Stage (1): Financial instruments whose credit quality has not significantly deteriorated since their initial recognition;

Stage (2): Financial instruments whose credit quality has significantly deteriorated since their initial recognition;

Stage (3): Financial instruments for which there is objective evidence of **impairment** as at the reporting date

For stage (1): Financial instruments; the **impairment** represents the **P.V** of expected credit **losses** that will result *if* a default occurs in the 12- months after the reporting date (12-months expected credit **losses**).

For financial instruments classified as stage (2) *or* (3), **impairment** is recognised at the **P.V** of expected credit **shortfalls** over their remaining life (**lifetime** expected credit **loss**). Entities are required to reduce the gross carrying amount of a financial asset in the period in which they no longer have a reasonable expectation of **recovery**.

Expected credit **losses** would be recognised in **P/L** and held in a separate allowance account (*although* this would not be required to be shown separately on the face of the SFP).

Financial assets in debt securities measured at F.V through **P/L** are not subject to **impairment testing** because changes in F.V are automatically recognised immediately in **P/L**.

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5/1. Debt instruments measured at amortised cost

1. **P.V of lifetime expected credit loss** is the expected **shortfall** in the contractual **future** cash flows **discounted** at the **original** effective interest rate of the **debt** instrument.

For example *if* the entity expects that a one year amount **due** of \$4m would be **impaired** by \$500,000 assuming the original discount rate is 10% *then*:

$$\text{P.V of lifetime expected credit loss} = \frac{\$500,000}{(1 + 0.10)^1} = \$454,545 \rightarrow \text{this amount would modify the current allowance (if any).}$$

2. *When* the entity agrees with the debtor to **wave** a portion of the amount owed *then*; the **impairment loss** = (carrying amount of the **financial asset** - **P.V** of future amount agreed on) **discounted** at the **original** effective interest rate.

3. In **measuring and recognising** the **credit loss**, the entity should deduct the estimated net recoverable amounts from the sale of any asset held as **collateral** to secure loan repayment.

4. Information regarding the financial difficulty of the debtor that gives evidence of conditions **arising after** the year-end is **non-adjusting** event. *Accordingly* the year-end **allowance** need not adjusted **but** the **financial instrument holder** should disclose the nature of the event **and** an estimate of its financial impact to the F/S⁵ users.

Illustrative example (1): On 1, Jan, 2018 Napa purchased a three years 10% **bond** for \$1m which is **measured at amortised cost**. The effective interest rate was 10%. On 31, Dec, 2018 Napa received interest of \$100,000. Napa estimated the probability of default on the **bond** within the **next 12-months** would be 0.50%. *If default occurs* Napa **estimated that** no further interest will be received *and* only 50% of the principal will be repaid on 31, Dec, 2020. The asset's **credit risk** at 31, Dec, 2018 is considered **low**. Assume effective interest rate at that date was 11%.

Required: Discuss the **accounting treatment** of the **bond** asset at 31, Dec, 2018.

Answer:

A. The **credit risk** on the **financial asset (bond)** has not significantly increased. *Therefore* a **loss allowance** should be made based on **12-months expected credit losses** (stage one).

B. **P.V of lifetime expected credit loss** is the expected **shortfall** in contractual cash flows **discounted** at the **original** effective interest rate (10%) as follows:

$$\text{P.V of lifetime expected credit loss} = \frac{\$100,000}{(1 + 0.10)^1} + \frac{\$600,000}{(1 + 0.10)^2} = \$586,777.$$

C. Expected credit loss (based on stage one) = debtor's default **Probability** in **next 12-months 0.50%** × **P.V** amount of **lifetime expected credit loss \$586,777** = \$2,934.

D. **Loss recognition**

Dr: **Impairment loss** on debt instrument \$2,934 → **P/L**

Cr: **Allowance** of credit risk \$2,934 → **contra financial asset**

E. Net carrying amount of the **bond** on 31, Dec, 2018 = \$1m - \$2,934 = \$997,066

F. Finance income in future periods will continue to be calculated on the **balance** of the **bond amortised cost (\$1m)**

Illustrative example (2): On 1, Feb, 2016 Eve made 6% annual in arrears four-year **loan** of \$10,000 to Fern. The effective interest rate was 6%. On 1, Feb, 2019 after receiving third annual interest Fern was in **significant** financial difficulties. At that time the current market interest rate was 8%. Eve **estimated that** it will receive no more interest **and** only \$6,000 of the principal will be repaid on **redemption** date. Eve has a previously **recognised loss allowance** of \$1,000 in respect of this **loan**.

Required: How should this event **accounted for**?

Answer: Evidence about **significant** financial difficulties of Fern mean that the **loan** is now **credit-impaired**.

P.V of lifetime expected credit loss is the expected **shortfall** in contractual cash flows **discounted** at the **original** effective interest rate of 6% as follows:

$$\text{P.V of lifetime expected credit loss} = \frac{\$600 \cdot \text{Interest} + \$4,000 \cdot \text{Principal}}{(1 + 0.06)^1} = \$4,340.$$

Expected credit loss based on stage three = debtor's default **Probability** in next 12-months **100%** × **P.V** amount of **lifetime** expected credit loss **\$4,340** = **\$4,340**.

Accordingly; **loss allowance** must be increased by **\$3,340** (\$4,340 - \$1,000).

Dr: Impairment loss on debt instrument \$3,340 → P/L

Cr: Allowance of credit risk \$3,340 → contra financial asset

SFP on 1, Feb, 2019	
Loan receivable	\$10,000
Less: Allowance of credit risk	(4,340)
Net	5,660

Because the **loan** is **significantly credit-impaired**, finance income should be calculated on **net** carrying amount of \$5,660.

Consequently in the last year of the **loan** finance income that should be **recognised in P/L** would be \$340 (\$5,660 × 6%).

But because Eve estimated that, it will receive no more interest from Fern *thus*; no finance income would be **recorded** for the last year of the **loan until** it actually received.

Illustrative example (3): The financial controller of Delta received a memo from his assistant as shown below.

On 1, Oct, 2017 we lent \$2m to a supplier in order to assist him with his expansion plans. We fully expected him to be able to repay us in full with ease. The **loan** cost us \$0.10m to arrange so I guess we need to charge it as cost in the current year? We agreed not to charge interest on this **loan** to help our supplier's short-term cash flow *but* expected the supplier to repay \$2.40m on 30, Sep, 2019. This will mean we **can't recognise** any income this year *but* there will be a nice bonus next year *when* we receive repayment. The finance department told me that the effective annual rate of interest on this **loan** is 6.90%. I don't understand the relevance of this information as no interest is payable.

Just before the year-ended 30, Sep, 2018 I **heard from the supplier** that the poor economic climate has caused him significant problems *and* in order to help him we **agreed** to reduce the amount repayable on 30, Sep, 2019 to \$2.20m. This still means we will report a profit next year though, doesn't it?

Required: Draft a reply to the question of your assistant **and** compute the impact on the **reported** profits for the year-ended 30, Sep, 2018.

Answer: The **loan** to the supplier would be *regarded as* a **financial asset** under IFRS Accounting Standard # 9 'Financial instruments' this **financial asset** is initially **measured** at **F.V.**

*When the business model is based on holding the **financial asset** to receive contractual interest and principal rather than dispose of the **financial asset** to third party then;* it is **measured** at **amortised cost** using effective interest rate.

Under **amortised cost** method, the **loan** transaction costs are included in its initial carrying value *rather than* being taken to **P/L**. This makes the **loan's** initial carrying value \$2.10m.

Under the effective interest method, part of the finance income is **recognised** in the current period.

Finance income **recognised** in the current period is \$144,900 (\$2.10m × 6.90%).

Dr: Loan receivable \$144,900

Cr: Finance income \$144,900

In the absence of information regarding the financial difficulties of the supplier, the **financial asset** at 30, Sep, 2018 would have been \$2,244,900 (\$2.10m + \$144,900).

The information regarding financial difficulty of the supplier is **objective evidence** that the **financial asset** has suffered **impairment** at 30, Sep, 2018. This **impairment** is **measured** under 'Stage three' **impairment loss**.

When the entity agrees with the debtor to wave a portion of the amount owed then; the **impairment loss** = carrying amount of the **financial asset** - **P.V** of future amount agreed on using the **original** effective interest rate.

$$\text{Impairment loss} = \$2,244,900 - \frac{\$2,200,000}{(1 + 0.069)^1} = \$186,902.$$

Expected credit loss-based on stage three = debtor's default **Probability** in next 12-months **100%** × **P.V** amount of **lifetime** expected credit loss **\$186,902** = \$186,902. This **impairment loss** is charged to **P/L** in the current period.

Delta is required to reduce the gross carrying amount of the **loan** to \$2,057,998 (\$2,244,900 - \$186,902) this amount represents the closing carrying amount of the **loan**. *Therefore* the net effect on **P/L** in the current period would be \$42,002 (**impairment loss** \$186,902 - finance income \$144,900).

Illustrative example (4): Delta is preparing its F/S^s for the year-ended 30, Sep, 2018. The F/S^s are authorised for issue on 30, Nov, 2018. On 1, April, 2018 Delta acquired 40m (\$1 par) **loan notes** in Epsilon at 90 cents each and is **redeemable** at \$1.20 on 31, March, 2023. Annual interest in arrears was 4% on par value. The effective annual interest rate is 9.90% Delta intends to hold the **financial asset** to **redemption**. Until 31, Oct, 2018 Epsilon was a successful entity. However on 31, Oct, 2018 three of Epsilon's major customers became insolvent and this caused liquidity problems for Epsilon. In Nov, 2018 Epsilon entered into negotiations with Delta. Delta agreed to forego interest payments due on 31, March, 2019 and 2020 with the payments from 31, March, 2021 onwards resuming as normal.

Required: Explain by quantifying amounts how this event would be **reported** in Delta F/S^s for the year-ended 30, Sep, 2018. You do not need to quantify amounts which are shown in notes to the F/S^s.

Answer: Per IFRS **Accounting Standard # 9 'Financial Instruments'** **financial assets** are measured at either **amortised cost** or **F.V** depending on the reason for holding them and the nature of the expected returns from the **financial assets**. In this case **amortised cost** is used because Delta's objective is to hold the **financial asset** to collect the contractual cash flows associated with it and those cash flows consist solely of the repayment of principal and interest. The **loan note** will initially be measured at \$36m ($40m \times 90 \text{ cents}$). Finance income for the six months to 30, Sep, 2018 will be \$1.782m ($\$36m \times 9.90\% \times 6/12$). The closing balance including interest receivable will be \$37.782m ($\$36m + \$1.782m$). This balance will be split into its current and **non-current** portions. Interest payment due on 31, March, 2019 of \$1.60m ($40m \times 4\%$) will be classified as current asset and the remaining of \$36.182m ($\$37.782m - \$1.60m$) will be classified as **non-current**. The information regarding the financial difficulty of Epsilon is an event after the reporting period. It is **non-adjusting** event as it gives evidence of conditions arising after the year-end. Therefore F/S^s are **not adjusted** but Delta should disclose the nature of the event and an estimate of its financial impact to the F/S^s users.

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5/2. Debt instruments measured at F.V through OCI

For financial assets in debt instruments measured at F.V through OCI; carrying value of the financial asset in SFP should not be reduced again; impairment loss is recognised against OCI.

Illustrative example: Rosalyn purchased a debt instrument for \$1,000 on 1, Jan, 2019 as its nominal value. The interest was received on year-end 31, Dec, 2019 and the F.V of the instrument was \$950 at that date. Assume no significant increase in credit risk since inception so expected credit loss is measured at \$30 based on 12-months expected credit loss.

Required: How the loss revaluation on debt instrument should be accounted for?

Answer:

1. The \$50 revaluation loss will be initially recognised in OCI.

Dr: OCI-equity \$50

Cr: Investment in debt instrument \$50

2. The 12-months expected credit losses of \$30 will be debited to P/L but it will not reduce the financial asset again rather it will be recorded against OCI.

Dr: Impairment loss on debt instrument \$30 → P/L

Cr: OCI-equity \$30

Therefore the cumulative loss in OCI is only \$20.

قياس واعتراف الخسارة الائتمانية بموجب "نموذج الخسارة الائتمانية المتوقعة بثلاث مراحل"

5/3. Debt instruments measured at F.V through P/L

Credit loss is automatically recognised in P/L when the financial asset is re-measured to its F.V. No allowance is established in this case.

Illustrative example: The financial controller of Omega received a query from the managing director after her review of the F/S^s for the year-ended 31, March, 2016 as follow:

On reviewing our F/S^s I have noticed that Omega have two types of financial assets; Type (A) that measured at amortised cost and Type (B) that measured at 'F.V through P/L'. It appears we carry out impairment review of Type (A) financial assets but not Type (B).

Please explain to me why this is the case and how an impairment review of Type (A) financial assets is carried out.

Required: Provide answers to the query raised by the managing director referring to relevant provisions of IFRS Accounting Standards.

Answer: A financial asset is considered impaired when its carrying amount can't be reasonably expected to be recovered through either future generation of income or sale proceeds IFRS Accounting Standard # 9 'Financial Instruments' classifies financial assets in debt instruments into three types. One of these types is 'F.V through P/L' any impairment loss on these financial assets is automatically reflected in the measurement basis so no further action is required. If financial assets in other categories are impaired; a loss allowance for the expected credit loss is recognised in P/L and deducted from the carrying amount of the financial asset in the SFP.

A credit loss is the difference between the cash flows we are contractually entitled to receive in respect of the financial asset and the cash flows which are expected based on current circumstances. Unless the credit risk attaching to the financial asset has increased significantly since initial or subsequent recognition, the loss allowance should be based on expected credit losses in the next 12-months. Where the credit risk has increased significantly, the loss allowance should be based on lifetime expected credit loss. As a simplifying measure; IFRS Accounting Standard # 9 allows the impairment loss on trade receivables and lease receivables to be always measured based on the lifetime expected credit losses.

6/1. Measuring credit loss on undrawn credit facilities

The 'three stage' expected credit loss model applies also to the undrawn portions of overdraft, credit card and other approved but undrawn credit facilities as follows:

Stage	Description	Credit loss is based on	Credit loss apply to
One	No significant increase in credit risk	12-months expected credit losses	Default Probability over the next 12-months × expected amount to be drawn down within next 12-months.
Two	Significant increase in credit risk	Lifetime credit losses	Default Probability over the lifetime × expected loss on amount to be drawn down over the life of the credit facility.

Illustrative example: Debita Bank applies the expected credit loss impairment model under IFRS Accounting Standard # 9. At 30, Sep, 2019 Debita approved total of \$10m overdraft facilities which have not yet been drawn. Debita considers that \$8m is in Stage one (i.e., no significant increase in credit risk). Of that \$8m in Stage one \$4m is expected to be drawn down within the next 12-months with 3% probability of default over the next 12-months. Debita considers that \$2m is in Stage two that is expected to be drawn over the remaining life of the facilities with lifetime probability of default of 10%.

Required: Calculate the required provision in respect of the undrawn overdraft facilities.

Answer:

Stage	Description	Calculation	Expected credit loss
One	No significant increase in credit risk	$3\% \times \$4m$	\$120,000
Two	Significant increase in credit risk	$10\% \times 2m$	200,000
Total	Under IFRS Accounting Standard # 9 Debita bank would recognise a provision of \$320,000 for the undrawn portion of its overdraft facilities		320,000

قياس الخسارة الائتمانية على الأصول المالية المتعثرة آتمائياً المشترأة أو المنشأ في أدوات الدين

7/1. Measuring credit loss on Purchased or originated credit-impaired financial assets in debt instruments

- 1.** A purchased *or* originated credit-impaired financial asset is a financial asset that is credit-impaired at initial recognition.
- 2. Finance income** is calculated on such financial assets using **credit-adjusted effective interest rate**; this rate should incorporate **all** expected credit losses. As expected credit losses increases, the rate used decreases. Accordingly **initially** anticipated credit losses, will be recognised through decreased finance income resulting from using the credit-adjusted effective interest rate.
- 3.** Subsequently both favorable *and* unfavorable changes in **lifetime** expected credit loss since initial recognition are recognised in P/L.

8/1. Simplified approach for trade and lease receivables

As a simplifying measure; IFRS Accounting Standard # 9 allowed loss allowance of trade receivables and lease receivables that do not have financing element to always be measured based on lifetime expected credit loss. Re-measurement loss or recoveries are recognised in P/L.

Illustrative example (1): On 1, June, 2019 Kredco sold goods for \$200,000 on 2 months credit to Detco. Kredco uses a pre-determined matrix for allowance calculation as follows:

Days overdue	Nil	1 - 30	31 - 60	61 - 90	Over 90
Expected credit loss allowance	1%	5%	15%	20%	25%

Detco failed to comply with credit terms and it had not paid by 31, July, 2019 because Detco was having serious cash flow difficulties due to key customer loss. Detco informed Kredco that it will pay.

Required: Show the accounting entries on 1, June, 2019 and 31, July, 2019 of the above in accordance with the expected credit loss model under IFRS Accounting Standard # 9.

Answer:

Recording sales at 1, June, 2019:

Dr: Trade receivable \$200,000

Cr: Revenue \$200,000

Initial expected credit loss allowance

For trade receivables that do not have financing element; IFRS Accounting Standard # 9 allow simplified approach to calculate expected credit loss; where the loss allowance is measured at the lifetime expected credit losses from initial recognition

Dr: Expected credit loss \$2,000 → P/L

Cr: Allowance for credit risk \$2,000

31, July, 2019:

Applying Kredco's matrix, Detco has moved into the 5% bracket. Despite assurances that Detco will pay, Kredco should increase the credit loss allowance to reflect the increased credit risk as follows:

Dr: Expected credit losses $[(\$200,000 \times 5\%) - \$2,000] = \$8,000 \rightarrow \text{P/L}$

Cr: Allowance for credit risk \$8,000

Illustrative example (2): Redblack has customer base consisting of large number of small clients. At 30, June, 2019 it has a portfolio of trade receivables of \$60m. Redblack applies IFRS Accounting Standard # 9 using an **allowance** matrix to determine the **expected credit losses** for the portfolio. The **allowance** matrix is based on historical observed default rates for forward looking estimates. The historical observed default rates are updated every reporting date. At 30, June, 2019 Redblack estimates the **following expected default** rate matrix:

Days overdue	Expected default rate	Gross trade receivables	Credit loss allowance Default rate × gross carrying amount
Current	0.30%	\$30m	\$90,000
1 to 30 days overdue	1.60%	15m	240,000
31 to 60 days overdue	3.60%	8m	288,000
61 to 90 days overdue	6.60%	5m	330,000
More than 90 days overdue	10.60%	2m	212,000
Total		60m	1.160m

At 30, June, 2020 Redblack has portfolio of trade receivables of \$68m. Redblack revises its forward looking estimates *and* the general economic conditions are deemed to be **less favorable** than previously thought.

The partially completed **allowance** matrix is as follows:

Days overdue	Expected default rate	Gross trade receivables
Current	0.50%	\$32m
1 to 30 days overdue	1.80%	16m
31 to 60 days overdue	3.80%	10m
61 to 90 days overdue	7%	7m
More than 90 days overdue	11%	3m
Total		68m

Required: Complete the provision matrix for Redblack at 30, June, 2020 *and* show the entry to record the **credit loss allowance** assuming **bad debt** during the year-ended 30, June, 2020 amounted to *either* \$1m or \$1.30m.

Answer:

Days overdue	Expected default rate	Gross carrying amount	Credit loss allowance Default rate × gross carrying amount
Current	0.50%	\$32m	0.160m
1 to 30 days overdue	1.80%	16m	0.288m
31 to 60 days overdue	3.80%	10m	0.380m
61 to 90 days overdue	7%	7m	0.490m
More than 90 days overdue	11%	3m	0.330m
Total		68m	1.648m

Description	Trade receivable Witten off during the year	
	\$1m	\$1.30m
Pre-adjusted allowance balance	\$1.160m - \$1m = \$0.160m Cr	\$1.160m - \$1.30m = \$0.140m Dr
Adjusting entry	Dr: Credit loss (\$1.648m - \$0.160m) = \$1.488m Cr: Allowance for credit risk \$1.488m	Dr: Credit loss (\$1.648m+ \$0.140m) = \$1.788m Cr: Allowance for credit risk \$1.788m

9/1. Criticisms to the expected loss model

- A. Expected **loss model** could result in earlier recognition of **credit loss** *than under* incurred **loss model** because it recognises not only incurred **credit loss** *but* also expected **credit loss**.
- B. Expected **loss model** requires significantly more judgment *when* considering information related to past, present *and* future. It relies on more forward-looking information. *Thus*; **credit loss** is recognised before it happens which reduces verifiability *and* increases chances for profits manipulation.
- C. Expected **loss model** implementation is more costly especially for entities that hold large volumes of **financial assets** in **debt** instruments *such as* banks.
- D. IASB *and* FASB approaches in **credit loss recognition** are different. *Thus*; significant differences arise in reported figures.

10/1. Disclosures

IFRS Accounting Standard # 9 requires extensive disclosures about the effect of deterioration *and* improvement in the credit risk of financial instruments including a description of inputs *and* assumptions used to measure expected credit loss.

المحاسبة عن خسارة الائتمان المتوقعة بموجب معيار المحاسبة الدولي رقم 9 في ضوء حالة عدم اليقين الحالية الناتجة عن جائحة كوفيد-19

11/1. Accounting for expected credit loss under IFRS Accounting Standard # 9 in the light of current uncertainty resulting from

The covid-19 pandemic

1. IFRS Accounting Standard # 9 sets out a framework for determining the amount of expected credit loss that should be recognised. It requires that; lifetime expected credit loss is recognised when there is a significant increase in credit risk on a financial instrument. However IFRS Accounting Standard # 9 does not set bright lines or a mechanistic approach to determining when lifetime loss are required to be recognised nor does it dictate the exact basis on which entities should determine forward-looking scenarios to consider when estimating expected credit loss.
2. IFRS Accounting Standard # 9 requires the application of judgement and requires entities to adjust their approach in determining expected credit loss in different circumstances. Currently used assumptions in determining expected credit loss may no longer hold in the current environment. Entities should not continue to apply their existing expected credit loss methodology mechanically. For example the extension of payment holidays to all borrowers in particular classes of financial instruments should not automatically result in all those instruments being considered to have suffered a significant increase in credit risk.
3. To assess significant increase in credit risk, IFRS Accounting Standard # 9 requires that entities assess changes in the risk of default occurring over the expected life of a financial instrument. This assessment of significant increase in credit risk and the measurement of expected credit losses must be based on reasonable and supportable information that is available to the entity without undue cost or effort.
4. Entities are required to develop estimates based on the best available information about past events, current conditions and forecasts of economic conditions. In assessing forecast conditions, consideration should be given to the effects of covid-19 and the significant support measures undertaken by the government.
5. It is likely to be difficult at this time to incorporate the specific effects of covid-19 and government support measures on a reasonable and supportable basis. However changes in economic conditions should be reflected in macroeconomic scenarios applied by entities and in their weights. If the effects of covid-19 can't be reflected in models; model adjustments will need to be considered. The environment is subject to rapid change and updated facts and circumstances should continue to be monitored as new information becomes available.
6. Although current circumstances are difficult and create high levels of uncertainty; if expected credit loss estimates are based on reasonable and supportable information and IFRS Accounting Standard # 9 is not applied mechanistically; useful information can be provided about expected credit loss. Indeed in the current stressed environment IFRS Accounting Standard # 9 and the associated disclosures can provide much needed transparency to F/S³ users.
7. Entities whose regulators have issued guidance regarding the application of IFRS Accounting Standard # 9 in the context of the covid-19 pandemic are encouraged to consider that guidance.

12/1. Indicators for impairment of equity instrument

1. Information about significant changes with an adverse effect in the technological, market, economic *or* legal environment in which the issuer operates.
2. A significant *or* prolonged decline in F.V of an investment in an equity instrument below its cost is also objective evidence of **impairment** recognition.

13/1. General

1. It is possible for a part of **financial asset or financial liability** to be **derecognised** **if** that part comprises specifically identified cash flows.

Ex: An investor in a **bond** has the right to two separate sets of cash inflows; (A) principal *and* (B) interest. The investor could **sell and derecognise** the right to receive interest *while* retaining the right to receive the principal *or* the investor could **sell and derecognise** only a pro-rata share of the total cash flows.

2. There are separate **derecognition** requirements for **financial assets and financial liabilities** as follows:

14/1. Derecognition of financial liabilities

Derecognition of the financial liability is ok when,

1. The **financial liability** is discharged, extinguished, cancelled or expired.

Illustrative example: Which of the following is not relevant factor when considering whether to **derecognise** a **financial liability**?

- A. Whether the **obligation** has been discharged;
- B. Whether the **obligation** has been canceled;
- C. Whether the **obligation** has expired;
- D. Whether substantially all the **risks and rewards** of the **obligation** have been transferred.

Answer (D) is correct.

2. The **financial liability** is **repurchased**.

Illustrative example: Kelso Co. repurchased a previously issued **bond** and it plans to reissue it.

Required: Does this repurchase warrant a **liability derecognition**?

Answer: Even if Kelso plans to reissue the **bond** when the issued **bond** was repurchased, Kelso **liability** was discharged. Accordingly the **liability** should be **derecognised** and the difference between the **bond** carrying value and its repurchase price is recognised as **G/L** in **P/L**.

3. A **substantial modification** of an existing **financial liability** terms or a part of it requires **derecognition** of the carrying value of the current **financial liability** and recognition of a new **financial liability** under the modified terms; **G/L** is recognised in **P/L**.

Notes:

- A. A **modification** is '**substantial**' when the discounted **P.V** of cash flows under the new terms (discounted using the original effective interest rate) is at least 10% different from the discounted **P.V** of the cash flows of the original **financial liability**.
- B. **G/L** is the difference between the carrying amount of the original **financial liability** and the **F.V** of the new **financial liability**.

Illustrative example: On 31, Dec, 2018 Fredrik Co. has a **loan** with face value \$300,000. Nominal interest 5% and matures on 31, Dec, 2020. The original effective market interest rate was 8%.

On 1, Jan, 2019 as a result of severe financial difficulties, Fredrik agreed with the creditor to modify the **loan** terms as follows:

- A. Annual interest rate will be 2% paid in arrears.
- B. The \$300,000 **loan** principal will be paid on 31, Dec, 2022.
- C. The effective interest rate on 1 Jan 2019 was 9%

Required: What is the **accounting treatment** of the previous **loan** modification on 1, Jan, 2019 assuming the **loan** was held under **amortised cost**?

Answer:

A. Carrying value of the original **loan** on 31, Dec, 2018 under **amortised cost** is the **P.V** of its future cash outflows

$$= \frac{(\$300,000 \times 5\%)}{(1 + 0.08)^1} + \frac{(\$300,000 \times 5\%)}{(1 + 0.08)^2} + \$300,000 = \$283,951$$

B. **P.V** of cash outflows under the **new terms** discounted using the **original effective interest rate**

$$= \frac{(\$300,000 \times 2\%)}{(1 + 0.08)^1} + \frac{(\$300,000 \times 2\%)}{(1 + 0.08)^2} + \frac{(\$300,000 \times 2\%)}{(1 + 0.08)^3} + \frac{(\$300,000 \times 2\%)}{(1 + 0.08)^4} + \$300,000 = \$240,382.$$

$$\text{C. Difference} = \frac{\$283,951 - \$240,382}{\$283,951} \times 100 = 15.34\% > 10\%.$$

Thus; the modification is considered **substantial**.

D. Appropriate entry on Fredrik records at 1, Jan, 2019:

Dr: **Loan payable** \$283,951 → **derecognition** of the original **loan**

Cr: **Loan payable** \$240,382 → **recognition** of the modified **loan**

Cr: **Gain on loan payable** modification \$43,569 → **P/L**

4. The borrower *and* lender **exchange** one **financial instrument** for another with **substantially** different terms; this requires **extinguishment** of the **original financial liability** *and* **recognition** of the **new financial liability**. **G/L** is recognised in **P/L**.

♦ **But financial liability** is **not derecognised** *when* the debtor set aside funds in a trust to **repay** the **liability** *such as* the debtor establishes a **bond sinking fund** (*so-called* in substance defeasance). **Debt sinking fund** is **presented** as a **financial asset** *and* never offset with the related **financial liability** because the debtor is **not legally discharged** from the **obligation**.

Revision: Evaluate the extent to which **derecognition** is appropriate in each of the following cases:

1. A **put option** written by entity (A) **expires**;
2. (A) owes (B) \$50,000 *and* has set aside that amount in a special trust that it will not use for any purpose *other than* to pay (B);
3. (A) **pays** (B) \$50,000 owed.

Answer:

1. **Derecognition** is appropriate because the **option** liability has expired. The entity no longer has an **obligation** *and* the **liability** has been extinguished.

2. **Derecognition** is **not** appropriate because (A) still owes (B) \$50,000. It has not legally released from paying this amount. **Debt sinking fund** is an **asset**.

3. **Derecognition** is appropriate because (A) has discharged its **obligation** to pay \$50,000.

Conclusion:

IFRS Accounting Standard # 9 simplified the previous complicated requirements of IAS # 39 by reducing the number of categories of **financial assets** into two categories; **amortised cost** and **F.V.**

'Available-for-sale' and 'held-to-maturity' categories that were included under IAS # 39 do not form part of IFRS Accounting Standard # 9. In short IFRS Accounting Standard # 9 uses a **principle-based model** as compared to a **rule-based model** that was prevailed under IAS # 39.

It reduces the complexity of recognition, reclassification and **impairment** models used.

15/1. Investment in equity securities of other entities

Simple investments in equity securities by any group member is accounted for under IFRS Accounting Standard # 9

Illustrative example (1): the following are investments in equity securities of other entities by the group members at 31, March, 2020 before adjustments:

Description	Parent	80% Sub (1)	75% Sub (2)
Investment in equity securities	\$30,000	\$40,000	\$10,000

The group members elected to measure these investments at F.V through OCI. None of these investments have been bought or sold in the year-ended 31, March, 2020. The F.V^s included in the draft SFP above represent the F.V^s at 31, March, 2019 for the parent and Sub (1) and the F.V at the date of Sub's (2) acquisition.

Relevant F.V^s as at 31, March, 2020 as follows:

- Parent; \$33m.
- Sub (1); \$43m.
- Sub (2); \$11.60m.

The change in the F.V of Sub (2) investments during the year-ended 31, March, 2020 was caused by events occurring after acquisition.

Assume deferred tax rate on T.D^s is 30%.

Required: Show the effects on consolidated F/S^s for the year-ended 31, March, 2020.

Answer:

Description	F.V at 31, March, 2020	Previous F.V	F.V change
Parent	\$33m	\$30m	\$3m
Sub (1)	43m	40m	3m
Sub (2)	11.60m	10m	1.60m
Total	87.60m	80m	7.60m

Description	Consolidated Statement of CI	Consolidated SFP
Recording changes in F.V and deferred tax effects	Dr: Investments in financial assets \$7.60m Cr: OCI-revaluation gain-Parent $(\$3 \times 70\%) = \$2.10m$ Cr: OCI-revaluation gain-Sub (1) $(\$3 \times 70\%) = \$2.10m$ Cr: OCI-revaluation gain-Sub (2) $(\$1.60 \times 70\%) = \$1.12m$ Cr: DTL $(\$7.60m \times 30\%) = \$2.28m$	Dr: Investments in financial assets \$7.60m Cr: Other component of equity $[(\$3m) + (\$3m \times 80\%) + (\$1.60m \times 75\%)] \times 70\% = \$4.62m$ Cr: NCI $[(\$3m \times 20\%) + (\$1.60m \times 25\%)] \times 70\% = \$0.70m$ Cr: DTL $\$7.60m \times 30\% = \$2.28m$

Illustrative example (2): The 75% owned Sub has a strategic equity investment in a key supplier. This investment does **not** give the Sub control *or* significant influence over the supplier. The supplier is not a joint arrangement for the Sub. The Sub directors made an irrevocable election at initial recognition of this investment to recognise all changes in F.V through OCI. The investment was included in the separate F/S^s of the Sub at its F.V of \$15m on 1, April, 2019. The F.V of this investment on 31, March 2020 was \$17m. In the tax jurisdiction in which the Sub is located, unrealised profits on the revaluation of equity investments are not subject to current tax.

Any such profits are taxed only *when* the investment is sold. Deferred tax rate for the Sub is 30%.

Required: Show the effects on consolidated F/S^s for the year-ended 31, March 2020.

Answer:

Des	Consolidated P/L and OCI	Consolidated SFP
Recording the change in F.V	Dr: Investments in financial assets \$2m Cr: OCI-revaluation gain-Sub $(\$2m \times 70\%) = \$1.40m$ Cr: DTL $(\$2m \times 30\%) = \$0.60m$	Dr: Investments in financial assets \$2m Cr: Other component of equity-Parent $(\$1.40m \times 75\%) = \$1.05m$ Cr: NCI $(\$1.40m \times 25\%) = \$0.35m$ Cr: DTL $(\$2m \times 30\%) = \0.60

Illustrative example (3): The parent has a portfolio of equity securities which are classified in accordance with IFRS Accounting Standard # 9 'Financial Instruments' as 'F.V through P/L'. The carrying amount included in the separate F/S^s of the parent at \$13m represents the F.V of the portfolio at 1, Oct, 2018 which has been correctly adjusted for purchases *and* disposals in the year. The F.V of the portfolio at 30, Sep, 2019 was \$13.80m

Required: Show the effects on consolidated F/S^s for the year-ended 30, Sep, 2019.

Answer:

Description	Consolidated P/L and OCI	Consolidated SFP
Recording the change in F.V	Dr: Investments in financial assets \$0.80m Cr: Investment income- Parent \$0.80m	Dr: Investments in financial assets \$0.80m Cr: R.E ^s \$0.80m

Illustrative example (4): During the period, the parent made a temporary investment of \$10m in a portfolio of listed securities. The market value of the portfolio (none of which was sold before the year-end) was \$9.50m.

Required: Show the effects on consolidated F/S^s for the year-ended 30, Sep, 2019.

Answer: Financial assets in equity securities held as temporary investment are measured at F.V through P/L.

Description	Consolidated P/L and OCI	Consolidated SFP
Recording the change in F.V	Dr: Investment income- Parent \$0.50m Cr: Investments in financial assets \$0.50m	Dr: R.E ^s - Parent \$0.50m Cr: Investments in financial assets \$0.50m

Illustrative example (5): The investments held by 40% associate relate to equity shares that have been designated as F.V through P/L. They were purchased during the current year at \$12m and are currently held at cost. At 30, April, 2020 these shares had a F.V of \$16m.

Required: Show the effects on consolidated F/S^s for the year-ended 30, April, 2020.

Answer: Parent's share in increased F.V of the associate investment portfolio = $[(\$16m - \$12m) \times 40\%] = \$1.60m$

Description	Consolidated P/L and OCI	Consolidated SFP
Recording the change in F.V	Dr: Investments in associates \$1.60m Cr: Earnings from associate- Parent \$1.60m	Dr: Investments in associates \$1.60m Cr: R.E ^s \$1.60m

Note: 'Investments in financial assets' account is not debited for the increase in F.V because associates are not consolidated; accordingly 'Investments in associates' account is debited by the parent's share of F.V gain on the associate's financial assets.

Illustrative example (6): On 1, Aug, 2017 the parent purchased an equity investment that was designated as a financial asset at F.V through OCI. On 31, March, 2019 the equity investment had F.V of \$7m and was included at this amount in the parent's separate and consolidated SFP. On 3, April, 2019 the parent disposed of this investment for net proceeds of \$7m. The cumulative gain of \$0.50m previously recognised in OCI has been reclassified and included within investment income.

Required: Show the effects on consolidated F/S^s for the year-ended 31, March, 2020.

Answer: Re-measurement G/L on changes in F.V of equity securities that are recognised in OCI are not reclassified to P/L when the investment is disposed of.

Des	Consolidated P/L and OCI	Consolidated SFP
Correction of inappropriate reclassification	Dr: Investment income- Parent \$0.50m Cr: OCI-revaluation gain- Parent \$0.50m	Dr: R.E ^s \$0.50m Cr: Other component of equity- Parent \$0.50m

15/2. Issuance of debt instruments

Illustrative example: Long-term borrowings of the parent include \$20m that was received from a consortium of banks on 1, April 2019.

The **loan** does not carry any interest *but* \$30.60m is repayable on 31, March 2024. The parent incurred incremental costs of \$1m in arranging the **loan** which were charged to **P/L** in the year-ended 31, March 2020 as other expenses. The effective annual rate of interest applicable to this **loan** is 10%.

Required: What is the adjusting effect on the consolidated F/Sⁱ for the year-ended 31, March, 2020?

Answer:

- Incremental costs of \$1m in arranging the **loan** reduces **loan** balance *rather than* charged to **P/L**. *Thus*, the **loan** balance would be \$19m
- Finance cost using effective interest method = $\$19m \times 10\% = \$1.90m$

Description	Consolidated P/L	Consolidated SFP
Reducing other expenses by loan issuance cost	Dr: Loan payable \$1m Cr: Other expenses- Parent \$1m	Dr: Loan payable \$1m Cr: R.E ^s \$1m
Recording finance cost on deep discount loan	Dr: Finance cost- Parent \$1.90m Cr: Loan payable 1.90m	Dr: R.E ^s \$1.90m Cr: Loan payable 1.90m

15/3. Purchase of a loan investment and lending third parties

Illustrative example (1): On 1, Oct, 2018 the parent purchased a **loan investment** that had a nominal value of \$1m at a cost of \$1.25m. The **investment** entitled the holder to a fixed rate of interest of 5% on the nominal value of the **loan** which has been included within revenue. The **investment** had a F.V of \$1.35m at 30, Sep, 2019.

Required: Show the effects on consolidated F/S^s for the year-ended 30, Sep, 2019 assuming the **investment** in **bond** is measured at F.V through OCI.

Answer: Interest received is not revenue *but* investment **income** (finance income)

Description	Consolidated P/L and OCI	Consolidated SFP
Reclassifying investment income from revenue to investment income	Dr: Revenue- Parent (\$1m × 5%) = \$50,000 Cr: Investments income-Parent \$50,000	No effect
Recording F.V gain on loan investment	Dr: Loan investment \$100,000 Cr: OCI-re-measurement gain- Parent \$100,000	Dr: Loan investment \$100,000 Cr: Other component of equity- Parent \$100,000

Note: According to IFRS Accounting Standard # 9 re-measurement G/L on investment in **debt securities** are re-classifiable to **P/L** when the **investment** is disposed of.

Illustrative example (2): On 1, Oct, 2018 the parent made an interest free **loan** of \$1.50m to a key supplier who was in financial difficulties. This **loan** is **repayable** on Sep, 2022. *If* the supplier had borrowed the money from a bank; it would have been charged annual interest of 12%. The parent has recorded the cash outflow *and* a corresponding **financial asset** at \$1.50m. No other accounting entries have been made *except* to correctly record the required **loss allowance**.

Required: Show the effects on consolidated F/S^s for the year-ended 30, Sep, 2019.

Answer:

- The **financial asset** (the **loan**) is measured at **amortised cost**.
 - The **financial asset** should have been initially recognised at its F.V *and* the difference is recognised in **P/L**.
 - F.V on 1, Oct, 2018 is the **P.V** of the **loan** discounted at 12% for four years = $\frac{\$1,500,000}{(1 + 0.12)^4} = \$953,277$.
 - Difference between **redeemable** amount of the **loan** *and* present value = \$1.50m - \$953,277 = \$546,723.
- This amount represents the total finance cost that would be borne by the parent.
- Unwinding discount on **loan receivable** = \$953,277 × 12% = \$114,393.

Description	Consolidated P/L	Consolidated SFP
Recording deferred finance cost on the loan	No effect	Dr: Deferred finance- Parent \$546,723 Cr: Loan receivable \$546,723
Recording F.V gain on loan investment	Dr: Loan receivable \$114,393 Cr: Finance income- Parent \$114,393	Dr: Loan receivable \$114,393 Cr: R.E ^s \$114,393
Recording finance cost on the loan	Dr: Finance cost- Parent \$114,393 Cr: Deferred finance cost \$114,393	Dr: R.E ^s \$114,393 Cr: Deferred finance cost \$114,393

15/4. Factoring of trade receivable

Remember: Factoring receivables with recourse is a **loan**.

Illustrative example: On 30, Sep, 2019 the parent sold trade receivables with a carrying value of \$25m to a finance company. The finance company paid \$20m *and* will pay the remaining balance less a collection charge that is based on the time taken to collect the cash from the relevant customers *when* the customers pay. *If* the customers do not pay by 31, March, 2020 *then*; any amounts advanced to the parent are **fully refundable**. There is currently no indication that any of the customers will not pay in full by that date. The parent debited cash with \$20m *and* credited trade receivables with \$25m the \$5m was charged as a finance cost in the statement of CI.

Required: Show the effects on consolidated F/S^s for the year-ended 30, Sep, 2019

Answer: This event is related to factoring trade receivable. Selling trade receivable (factoring) is done **with recourse**. So trade receivables should **not** be eliminated because the **parent** assumes the **risk of loss**. *Accordingly* receivables must be **reinstated** because the factoring occurred at the last day of the year *so* **no finance cost** should be accrued at that date.

Description	Consolidated P/L	Consolidated SFP
Restating trade receivables	Dr: Trade receivables \$25m Cr: Finance cost- Parent \$5m Cr: Short term loan payable \$20m	Dr: Trade receivables \$25m Cr: R.E ^s \$5m Cr: Short term loan payable \$20m